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## An Analysis of Recent Proposals for Reform of Federal Securities Legislation

William H. Painter  
*University of Illinois*

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# AN ANALYSIS OF RECENT PROPOSALS FOR REFORM OF FEDERAL SECURITIES LEGISLATION

*William H. Painter*

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# AN ANALYSIS OF RECENT PROPOSALS FOR REFORM OF FEDERAL SECURITIES LEGISLATION

*William H. Painter\**

**T**ODAY the securities industry is in the midst of rapid change. Indeed it has been for at least the past decade,<sup>1</sup> but in recent years the pace of change has increased, and its emphasis has shifted. Legislative and administrative reforms that could not have been anticipated a decade ago are likely in the near future, and it is still impossible to predict accurately the shape of the markets of tomorrow or the rules by which they will be governed. It is the purpose of this Article to focus on these recent developments, to summarize and evaluate various proposals for reform, and to attempt a rough prediction of the shape of things to come—although prophecy is at best an inexact, if not a hazardous, endeavor.

## I. BACKGROUND OF THE RECENT CHANGES

The seeds of the present developments were sown over the past decade by two major and interrelated phenomena. The first is the rapid institutionalization of the securities markets. Not only do institutions such as investment companies, pension funds, bank trust departments, and insurance companies own increasing percentages of the outstanding equities of large, publicly held corporations,<sup>2</sup> but,

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\* Professor of Law, University of Illinois. A.B. 1950, Princeton University; LL.B. 1954, Harvard University. The author served as Special Counsel and Director of the House of Representatives Study of the Securities Industry, Subcommittee on Commerce and Finance, Committee on Interstate and Foreign Commerce, 92d Cong., 1st and 2d Sess. (1971-1972). The views contained herein are those of the author and do not necessarily represent those of the committee or its subcommittee.

1. The most important changes that occurred in the early and middle 1960's were the various reforms resulting from the Securities and Exchange Commission's (SEC) REPORT OF SPECIAL STUDY OF SECURITIES MARKETS (H.R. Doc. No. 95, 88th Cong., 1st Sess. (1963)) [hereinafter SPECIAL STUDY] and the rapid evolution of SEC anti-fraud provisions, particularly rule 10b-5, 17 C.F.R. § 240.10b-5 (1973), which today extends far beyond the fraud area to cover such problems as insider trading by investment advisors and securities analysts, false or misleading press releases, and other activities that formerly were thought to be governed exclusively by state law. *See generally* 1 A. BROMBERG, SECURITIES LAW: FRAUD—SEC RULE 10b-5, §§ 2.2-4 (1971); 3 L. LOSS, SECURITIES REGULATION 1445-74 (2d ed. 1961); 6 *id.* 3556-3647 (Supp. 1969); W. PAINTER, FEDERAL REGULATION OF INSIDER TRADING 19-23, 153-67, 310-16 (1968).

2. 5 SECURITIES & EXCHANGE COMMN., INSTITUTIONAL INVESTOR STUDY REPORT 2549-715 (H.R. Doc. No. 92-64, 92d Cong., 1st Sess. (1971)) [hereinafter INSTITUTIONAL INVESTOR STUDY]. For example, institutional holdings of stocks listed on the New York Stock Exchange (NYSE) grew from 12.7 per cent in 1949 to 17.2 per cent in 1959, 26.6 per cent in 1970, and 28.3 per cent in 1971. These percentages do not include holdings of

because of the institutional investor's emphasis on short-term performance, rather than long-term investment, as a philosophy of portfolio management, an increasing percentage of dollar and share volume trading on the exchanges and the third and fourth markets<sup>3</sup> has been due to institutional activity.<sup>4</sup> The second phenomenon is the resistance of the securities business to the pressures for internal changes caused by such institutionalization. The primary areas in which change has been resisted are (a) the system of fixed commission rates charged by members of exchanges to nonmember broker-dealers or to members of the public, and (b) the method of

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bank-administered personal trust funds and foreign institutions. If the latter were included, along with mutual funds not registered with the SEC, private hedge funds, and nonbank trusts, the percentage of institutionally owned NYSE-listed stocks would probably have been in excess of 40 per cent as of the end of 1971. NEW YORK STOCK EXCHANGE, INC., FACT BOOK 50 (1972) [hereinafter NYSE FACT BOOK].

3. The "third market" is a term applied to over-the-counter trading in NYSE-listed securities by non-NYSE member firms. The "fourth market" refers to direct trading between investors who thereby avoid the use of a broker. S. ROBBINS, *THE SECURITIES MARKETS* 253, 257 (1966).

4. Institutional trading on the NYSE, expressed as a percentage of share volume, grew from 26.2 per cent in 1961 to 42.4 per cent in 1969 and 45.7 per cent in the first half of 1971. NYSE FACT BOOK, *supra* note 2, at 52. Expressed as a percentage of dollar volume, such trading amounted to 29.2 per cent in 1961, 46.2 per cent in 1969, and 52.4 per cent in the first half of 1971. *Id.* In terms of public volume on the NYSE (*i.e.*, omitting trades of member firms for their own accounts), institutional participation in trading (as compared with public individual participation) is even greater. Such participation in 1961, 1969, and the first half of 1971, expressed in terms of share volume, was 33.3 per cent, 55.9 per cent, and 59.7 per cent, respectively. In terms of dollar volume, such participation was 38.7 per cent, 61.9 per cent, and 68.2 per cent during these respective periods. *Id.* at 53. As previously indicated, *see* note 2 *supra*, these percentage figures would be higher if trading by foreign institutions and bank-administered personal trust funds were included.

Although trading by individuals rose during these years, trading by institutions rose at a substantially greater rate. Thus, by the middle of 1971 individuals accounted for only 30.8 per cent of the NYSE's total share volume and less than 25 per cent of the NYSE's dollar volume. NYSE FACT BOOK, *supra* note 2, at 52.

The percentage of trading by individuals has also declined on other markets. *Id.* at 53. In addition, the total value of shares traded in other markets has steadily increased. For example, the market value of shares traded on regional exchanges (as a percentage of the market value of shares traded on all registered exchanges) increased from 6.8 per cent in 1961 to 10.9 per cent in 1971. Third market trading increased from 2.7 per cent in the first quarter of 1967 to 7.8 per cent in the fourth quarter of 1971 (expressed as a percentage of total NYSE trading). SUBCOMM. ON COMMERCE AND FINANCE OF THE HOUSE COMM. ON INTERSTATE AND FOREIGN COMMERCE, *SECURITIES INDUSTRY STUDY*, H.R. REP. NO. 92-1519, 92d Cong., 2d Sess. 117, 130 (1972) [hereinafter HOUSE REPORT]. For further statistics, *see* SUBCOMM. ON SECURITIES OF THE SENATE COMM. ON BANKING, HOUSING AND URBAN AFFAIRS, *SECURITIES INDUSTRY STUDY*, S. DOC. NO. 93-13, 93d Cong., 1st Sess. 92 (1973) [hereinafter SENATE REPORT], which indicates that the percentage of trading taking place on regional exchanges and the third market in the most actively traded NYSE-listed stocks is significantly higher than the percentage for all such listed stocks. Thus, in the fourth quarter of 1971, 30.3 per cent of the total trading in 50 of the most active issues took place on regional exchanges or in the third market. In the case of one stock, Procter & Gamble, 52.6 per cent of the trading was on markets other than the NYSE.

processing securities transactions—from a customer's order, to its execution on the floor of an exchange or in the over-the-counter market, to the eventual delivery of one or more stock certificates.

The catalyst that increased the pressure for change in the industry was the severe financial crisis in the markets from 1967 until late 1970. The "bull" market that existed in the early part of the period created a mood of euphoria among many investors, particularly those interested in speculation or short-term profit, and among broker-dealers, who profited from the steadily rising prices and high trading volume. But these conditions carried with them the classic signs of instability, as underlying fundamentals of investment were sacrificed to the lure of rapid performance. The investment sometimes became less important than the prospect of reselling the security at a profit to a "bigger fool."

The securities industry's response to these market conditions was, if not predictable, at least characteristic. Firms expanded their sales forces to meet the increased needs generated by investor enthusiasm but failed to provide the proper logistical support of a corresponding expansion and modernization of facilities for processing securities transactions. As one writer put it:

A middle-aged investor who dealt with the same brokerage firm during the past 25 years might have observed that, as volume mounted, striking transformations occurred in the physical appearance of the office, the character of the personnel, and the speed with which he was able to obtain information. The board room that he visited to check the current status of the market was more comfortable and the visual displays more complete and easier to see. . . . The investor now could obtain a wide range of current statistics on price, volume, dividends, and earnings by simply pressing the appropriate keys of an electronic machine. All in all, he would be very pleased, not only with the conveniences afforded him, but because these very same innovations indicated the firm's ability to keep pace with changing times . . . . But had he asked for a description of the path his order took, from the time he submitted it until he finally received a stock certificate, his registered representative might have presented a flow diagram yellowed with age. In other words, from a systems viewpoint, there was little change.

. . . .  
Had the customer visited the backoffice of his brokerage house, he probably would have experienced a growing discomfort. Threading his way through the crowds of personnel hurrying about their business, he would find that more people in the same physical location made the atmosphere denser, the noise louder, and the general environment dingier.<sup>5</sup>

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5. S. Robbins, W. Werner, C. Johnson & A. Greenwald, *Paper Crisis in the Securities*

The stock certificate, although an integral part of the paperwork problem, was only partially responsible for the reigning confusion and complexity, for many other pieces of paper were also involved. A typical broker-dealer uses at least thirty-three different documents in a single transaction; an error in any step of the chain may double the number of documents required.<sup>6</sup> Indeed, in one large brokerage firm, no fewer than 210 pieces of paper were required to consummate a single transaction.<sup>7</sup> With each additional step, the likelihood of losing securities increased. Added to the confusion of paperwork was the problem of theft of certificates while they were being delivered from one broker to another or to a clearing house. Estimates in 1971 of the total amount of stolen or missing securities range from 1.2 billion dollars to ten billion dollars.<sup>8</sup> The failure of one brokerage firm was attributed to a theft of securities worth 1.8 million dollars.<sup>9</sup>

Brokerage firms euphemistically describe stolen or missing securities as short stock record differences or short securities differences. These generic terms also embrace securities that cannot be located even though firm records indicate that they should be in the firm's possession or otherwise accounted for (as, for instance, having been pledged as collateral for a loan). Conversely, long stock record differences are securities on hand, the ownership of which the firm cannot ascertain. During the period leading up to the financial crisis, both short and long stock record differences often amounted to

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Industry: Causes and Cures 22-23 (Lybrand, Ross Bros. & Montgomery 1969), reprinted in *Hearings on the Securities Industry Before the Subcomm. on Commerce and Finance of the House Comm. on Interstate and Foreign Commerce*, 92d Cong., 1st Sess., pt. 4, at 2159, 2187-88 (1971) [hereinafter *House Hearings*].

6. North American Rockwell Information Systems Co., Securities Industries Overview Study 13 (1969), reprinted in *House Hearings*, *supra* note 5, pt. 4, at 2069; *HOUSE REPORT*, *supra* note 4, at 60.

7. *House Hearings*, *supra* note 5, pt. 3, at 1597 (testimony of Robert R. Maller, vice-president, United States Trust Co. of New York).

8. *HOUSE REPORT*, *supra* note 4, at 75. An even higher estimate was recently given by W. Henry DuPont, Chairman of the Securities Validation Corporation, who told the Permanent Investigations Subcommittee of the Senate Government Operations Committee in early 1973 that the probable amount of lost, missing, and stolen government, state, municipal, and corporate securities may be in the neighborhood of 50 billion dollars. BNA SEC. REG. & L. REP. No. 209, at A-10 (July 4, 1973). For reports of other testimony before the Senate Permanent Investigations Subcommittee regarding crime in the securities industry, see Wall St. J., July 16, 1973, at 8, col. 3 (midwest ed.); N.Y. Times, July 14, 1973, at 1, col. 5 (city ed.).

9. *HOUSE REPORT*, *supra* note 4, at 75. More recently, then Attorney General Richard Kleindienst, in an address to the Trust Division of American Bankers Association, reported that the amount of stocks and bonds stolen annually had been reduced from an estimated 675 million dollars in 1971 to 270 million dollars in 1972, but that thefts still continue to threaten a "serious disruption" of the securities business. BNA. SEC. REG. & L. REP. No. 188, at A-12 (Feb. 7, 1973).

millions of dollars of securities.<sup>10</sup> Although some firms attempted to offset their short securities differences by the amount of their long securities differences, this practice was misleading, for it assumed that a missing security can be replaced by a security whose ownership is in doubt. Replacement can occur only if the true ownership of the latter security is never ascertained, and, even then, it is probable that securities of unknown ownership are subject to state laws governing escheat or disposition of abandoned property.<sup>11</sup>

As volume of trading mounted, inadequate bookkeeping and slipshod methods of handling the mechanical aspects of trades, generally referred to as clearance and settlement, caused some firms to lose control over their own procedures. Control, once lost, was difficult to regain, since personnel would generally find it necessary to process current trades before researching long or short securities differences. Thus, the problem tended to feed upon itself, and difficulties multiplied. Shoddy bookkeeping practices or loss of operational control in one firm could create problems in other firms.<sup>12</sup> For instance, if one firm failed to deliver securities to another on the date agreed upon,<sup>13</sup> the "fail to deliver," although described for bookkeeping purposes as an asset ("fails to receive") by the second firm, would frequently hamper its ability to meet its commitments to third parties. Although the level of fails has generally been considered a good indicator of the operational problems of the brokerage business, data on fails were not compiled prior to April 1968.<sup>14</sup> By the end of that year, the level of fails had climbed to a high of 4.13 billion dollars.<sup>15</sup> Although the level gradually declined thereafter (rising briefly again in 1971 after the crisis had passed),<sup>16</sup> problems of operational control persisted.

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10. SECURITIES & EXCHANGE COMM., STUDY OF UNSAFE AND UNSOUND PRACTICES OF BROKERS AND DEALERS 100-05 (H.R. DOC. NO. 92-231, 92d Cong., 1st Sess. (1971)) [hereinafter SEC UNSAFE AND UNSOUND PRACTICES STUDY]. See also H. BARUCH, WALL STREET: SECURITY RISK 94-96 (1971).

11. See H. BARUCH, *supra* note 10, at 140.

12. The possible "domino" effect of a failure of one or more brokerage houses and the high degree of interdependence among broker-dealer firms is discussed in SENATE REPORT, *supra* note 4, at 38.

13. Until February of 1968 the settlement period for regular transactions was four business days. This was extended to five business days as part of the effort to meet the financial crisis. See *House Hearings, supra* note 5, pt. 1, at 32; NYSE Rule 64, 2 CCH NYSE GUIDE ¶ 2064 (1968).

14. HOUSE REPORT, *supra* note 4, at 5; *House Hearings, supra* note 5, pt. 1, at 19.

15. *House Hearings, supra* note 5, pt. 1, at 11, 33; HOUSE REPORT, *supra* note 4, at 5. The data are limited to NYSE member firm trades in both listed and unlisted securities. For similar data covering a statistical sampling of National Association of Securities Dealers (NASD) member firms that are not NYSE or American Stock Exchange (AMEX) members, see *House Hearings, supra* note 5, pt. 1, at 43-44.

16. *House Hearings, supra* note 5, pt. 1, at 11, 44.

The sharp drop in securities prices that began early in 1969, accompanied by a decline in the volume of trading later that year, had the effect of whipsawing firms plagued with the troubles already described, and many firms were eventually forced to close their doors.<sup>17</sup> Shrinking commission income was inadequate to finance the resolution of past operational problems or to support the expanded sales organizations and branch offices acquired in the preceding bull market. Firms were forced to curtail their operations and suffer further losses of commission income. Moreover, the sharp drop in securities prices created deficiencies in firm capital invested in securities. In some instances, securities held in firm capital accounts were found to have little or no marketability (as in the case of restricted or letter stock).<sup>18</sup> Firms that had derived working capital through the use of customers' free credit balances or excess margin securities<sup>19</sup> experienced a similar capital decline when the value of the securities in customers' margin accounts fell and the accounts were closed out to meet margin calls. Customers grew increasingly intent on retrieving any credit balances in their favor, thus adding to the firms' financial decline. Finally, the capital problems of many firms were exacerbated by withdrawals of capital contributed to firms through subordinated loans, the terms of which commonly provided for termination after a few months' notice.<sup>20</sup>

As may be evident from the foregoing, the financial crisis and collapse of brokerage firms were only superficially due to the whipsaw conditions created by the high volume bull market followed by the shrinking volume bear market of 1969-1970. More profound reasons for the crisis were the overemphasis on sales to the detriment of more mundane back office operations, slipshod and inadequate bookkeeping, archaic procedures for processing trades, excessive

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17. The financial crisis and its causes are discussed in greater detail in House REPORT, *supra* note 4, at 9-12.

18. *House Hearings*, *supra* note 5, pt. 2, at 753 (statement of Irving M. Pollack, then Director of the SEC's Division of Trading and Markets). "Restricted" or "letter" stock is stock that normally cannot be disposed of without registration under the Securities Act of 1933, 15 U.S.C. §§ 77a-77aa (1970).

19. "Free credit balances" are amounts payable on demand to customers of broker-dealers. They may arise from a cash deposit by a customer with a broker-dealer in anticipation of the customer's placing an order to purchase securities, from a sale of a customer's securities when the broker-dealer holds the proceeds pending instructions by the customer, or from the broker-dealer's receipt of dividends or interest on the customer's securities. See HOUSE REPORT, *supra* note 4, at 38. "Excess margin securities" are those securities in a customer's margin account having a market value in excess of the amount required to be maintained on deposit to secure his margin indebtedness. See SEC UNSAFE AND UNSOUND PRACTICES STUDY, *supra* note 10, at 125. Statistics on the level of both free credit balances and excess margin securities for the years 1968-1970 at the twenty-five largest NYSE member firms are collected in *id.* at 141-43, tables 14 & 15.

20. See SEC UNSAFE AND UNSOUND PRACTICES STUDY, *supra* note 10, at 54-63.



dependence on customers' funds and securities for working capital, unwise investment of firm capital in speculative stocks, and the transitory or ephemeral character of capital derived from subordinated loans than can be withdrawn on short notice. In view of this, it might well be asked not why there were so many brokerage failures, but how the industry itself managed to survive.

Reaction to the crisis in the securities markets was quick. In 1970, Congress passed the Securities Investor Protection Act<sup>21</sup> to provide insurance protection for customers of insolvent brokerage

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21. Pub. L. No. 91-598, 84 Stat. 1636 (codified at 15 U.S.C. §§ 78aaa-78lll (1970)). Probably the most important effect of the Act was its establishment of the Securities Investor Protection Corporation (SIPC) to provide insurance protection for customers of insolvent brokerage firms. Securities Investor Protection Act of 1970, § 3, 15 U.S.C. § 78ccc (1970). The corporation provides coverage of up to 50,000 dollars for the account of any one customer of a member broker-dealer; however, only 20,000 dollars of that sum may be allocated to reimbursement of losses in cash accounts. Securities Investor Protection Act of 1970, § 6(f)(1), 15 U.S.C. § 78fff(f)(1) (1970).

The Act requires membership in SIPC for all broker-dealers who are members of a national securities exchange and for those registered as brokers or dealers under section 15(b) of the Securities Exchange Act of 1934, 15 U.S.C. § 78o(b) (1970), except those whose business consists exclusively of (i) the distribution of shares of registered open end investment companies or unit investment trusts, (ii) the sale of variable annuities, (iii) the business of insurance, or (iv) the business of rendering investment advisor services to one or more registered investment companies or insurance company separate accounts. Securities Investor Protection Act of 1970, § 3(a), 15 U.S.C. § 78ccc (a) (1970).

SIPC is financed by assessments collected from its members. If the fund created by such assessments should prove inadequate to reimburse customers for losses (as in some major financial catastrophe), SIPC is authorized to borrow from the United States Treasury upon a line of credit in the amount of one billion dollars. Securities Investor Protection Act of 1970, § 4, 15 U.S.C. § 78ddd (1970).

Among the other important features of the legislation are provisions authorizing SIPC to apply for judicial appointment of a trustee for member firms in the event of the occurrence of certain specified conditions, such as insolvency, bankruptcy, or failure to comply with SEC or other rules relating to financial responsibility or hypothecation of customers' securities. Securities Investor Protection Act of 1970, § 5, 15 U.S.C. § 78eee (1970). The purpose of such a proceeding is to liquidate the affairs of the member firm and to return to customers as promptly as possible their "specifically identifiable property" or, if their property cannot be identified, to make payments to customers from a "single and separate fund" held for customers' accounts. Securities Investor Protection Act of 1970, § 6, 15 U.S.C. § 78fff (1970).

In addition, section 15(c)(3) of the Securities Exchange Act of 1934 was amended to require the SEC to promulgate rules requiring the "maintenance of reserves with respect to customers' deposits or credit balances" and to allow the SEC to promulgate rules dealing with the acceptance of custody and use by broker-dealers of customers' securities. Securities Investor Protection Act of 1970, § 7(d), 15 U.S.C. § 78o(c)(3) (1970).

The Act has not been given retroactive effect. *Lohf v. Casey*, 466 F.2d 618 (10th Cir. 1972). See also *SEC v. Alan F. Hughes, Inc.*, 461 F.2d 974 (2d Cir. 1972) (upheld procedure for appointing receiver of brokerage firm); *Bohart-McCaslin Ventures, Inc. v. Midwestern Sec. Corp.*, 352 F. Supp. 937 (N.D. Tex. 1973) (customer of broker-dealer held to have no individual cause of action under the statute). See generally Note, *Securities Investor Protection Act of 1970: An Early Assessment*, 73 COLUM. L. REV. 802 (1973).

firms. Both branches of Congress commissioned thorough studies of the problems underlying the 1967-1970 crisis; the House Committee's Report was submitted in October 1972,<sup>22</sup> and the Senate Committee's Report was completed in February 1973.<sup>23</sup> At the same time, four other studies of the securities markets were conducted, three by the Securities and Exchange Commission (SEC)<sup>24</sup> and one by William McChesney Martin, Jr., former Chairman of the Board of Governors of the Federal Reserve System and former President of the New York Stock Exchange (NYSE).<sup>25</sup> Thus, during a two-year period the securities industry was the subject of at least six separate major studies, while many other studies were made of particular problems, such as clearance and settlement procedures, the development of a machine-readable certificate, and the complete elimination of the stock certificate.<sup>26</sup>

To attempt to summarize and compare in detail the findings, recommendations, and ramifications of all of these studies would be difficult and somewhat hazardous. Perhaps the best way in which to approach the problem is to concentrate on certain major areas in which reforms or changes are likely, using the congressional studies as a point of reference. In this way, the proposals made by each study on a particular topic may be contrasted, and some indication of likely legislative or administrative changes may be obtained.

There are at least three principal areas of interest: (1) methods of strengthening and promoting broker-dealer financial stability and simplifying procedures for processing securities transactions; (2) methods of strengthening the mechanism of self-regulation; and (3) changes in the structure of the market to lessen tensions created by the interrelationship between the institutionalization of the markets and the commission rate structure.

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22. See HOUSE REPORT, *supra* note 4.

23. See SENATE REPORT, *supra* note 4.

24. See INSTITUTIONAL INVESTOR STUDY, *supra* note 2; SEC UNSAFE AND UNSOUND PRACTICES STUDY, *supra* note 10; *Hearings on Structure, Operation and Regulation of Securities Markets Before the Securities & Exchange Commn.* (File No. 4-147, 1971). These hearings resulted in a far-reaching policy statement, Securities & Exchange Commn., Future Structure of the Securities Markets, SEC Securities Exchange Act Release No. 9484 (Feb. 2, 1972), 37 Fed. Reg. 5286 (1972), reprinted in *House Hearings, supra* note 5, pt. 7, at 3445-59 [hereinafter SEC Future Market Structure Statement].

25. W. Martin, *The Securities Markets—A Report, With Recommendations* (1971), reprinted in *House Hearings, supra* note 5, pt. 6, at 3189-215 [hereinafter Martin Report]. The Martin Report was submitted to the NYSE Board of Governors on August 5, 1971.

26. See HOUSE REPORT, *supra* note 4, at 62-63. Many of the studies of specific problems are contained in the *House Hearings, supra* note 5, pts. 4 & 5, at 2055-889.

## II. BROKER-DEALER FINANCIAL STABILITY

A. *Uniform Net Capital Requirements*

A weakness of the regulatory structure in the past has been the diversity of rules applicable to broker-dealers. An illustration of this is the SEC's requirement of a specified minimum net capital for entry into the brokerage business.<sup>27</sup> To remain in the brokerage business, a broker-dealer must also maintain a specified net capital ratio, defined as the relationship between a broker's aggregate indebtedness<sup>28</sup> and his net capital.<sup>29</sup> The SEC exempted members of principal national securities exchanges from the application of its net capital rule because it found that the requirements of the exchanges' own rules were "more comprehensive" than those of the SEC rules.<sup>30</sup> Although this may have been true when the SEC's exemption was granted, many exchanges subsequently loosened their interpretations of the net capital requirements, so that member firms became subject to equal or more lenient standards than firms that were not members of exchanges. For example, although the NYSE required a net capital ratio of fifteen to one in November 1944, the effective date of its exemption from the SEC rule, the figure was eventually raised to twenty to one, the same ratio as that prescribed by the SEC.<sup>31</sup> Moreover, the exchanges and the SEC followed different pro-

27. A broker's net capital is his net worth (*i.e.*, the excess of total assets over total liabilities), adjusted by unrealized profits and losses and deductions for the value of assets that are not readily convertible into cash and for a percentage of the market value of liquid assets that might decrease in value before they are sold. *See* 17 C.F.R. § 240.15c3-1(c)(2) (1973).

Under the SEC's recently amended rule, a broker-dealer who carries customers' accounts and engages in the general brokerage business must have a minimum net capital of 25,000 dollars. Broker-dealers who engage exclusively in selling mutual funds and do not engage in the general brokerage business are subject to lesser requirements. 17 C.F.R. § 240.15c3-1(a) (1973).

The NYSE imposes minimum requirements ranging from 25,000 dollars to 100,000 dollars, depending upon the type of business done by a member firm. *See* NYSE Rule 325(a), 2 CCH NYSE GUMS ¶ 2325(a) (1973).

28. *See* 17 C.F.R. § 240.15c3-1(c)(1) (1973) for the SEC's definition of aggregate indebtedness.

29. 17 C.F.R. § 240.15c3-1(a) (1973). The present ratio required by the SEC is 20:1 (*i.e.*, aggregate indebtedness cannot exceed 20 times net capital), but a proposed revision of rule 15c3-1 will require a ratio of 15:1. Under the proposed revision at least 30 per cent of a firm's capital would have to be in the form of equity. *See* Securities Exchange Act Release No. 9891 (Dec. 5, 1972), 38 Fed. Reg. 56 (1973). During a broker-dealer's first year of business it would be subject to a minimum net capital ratio of 8:1. *Id.*

30. 17 C.F.R. § 240.15c3-1(b)(2) (1973). The exchanges so exempted are the AMEX, the Boston Stock Exchange, the Midwest Stock Exchange, the NYSE, the Pacific Coast Stock Exchange, the Philadelphia-Baltimore-Washington (PBW) Stock Exchange, and the Chicago Board Options Exchange, Inc.

31. The NYSE applied a 20:1 ratio from September 1, 1953, to August 1, 1971, when

cedures in computing net capital. For example, the NYSE gave credit for temporary debt capital provided by subordinated loan agreements, even though such capital might be withdrawn on short notice.<sup>32</sup> The SEC, on the other hand, required cash or securities included in the computation to be loaned for at least one year under a "satisfactory subordination agreement" and prohibited repayment of the loan when the effect of the repayment would be to put the firm in violation of the net capital rule or when the firm was already in violation of the rule.<sup>33</sup> Although the SEC required that short security differences be deducted in the net capital computation,<sup>34</sup> the NYSE changed the interpretation of its rule to require deduction of only such reserves as a member firm might choose to set aside to cover the differences. Firms that had established only a minimal reserve, or no reserve at all, were thus able to meet the NYSE's net capital test even though they had substantial short security differences on their books. This relaxation in the NYSE's rule took place in May 1969 and reflected the substantial short security differences that had accumulated on the books of member firms during the financial crisis. The NYSE apparently believed that it was more prudent to loosen its net capital rule than to interpret the rule strictly and close down large numbers of its member firms.<sup>35</sup> Finally, the NYSE permitted credit for such items as unsecured receivables (such as tax refund and insurance claims), unmarketable securities (such as restricted or letter stock), and deposits with clearing corporations; under the SEC's rule, such items were not eligible for inclusion in the net capital computation.<sup>36</sup>

Although substantial reforms were made in the NYSE's net capital rule after the financial crisis had passed,<sup>37</sup> the House subcom-

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it returned to the original 15:1 ratio. See Dept. of Member Firms, New York Stock Exchange, Inc., M.F. Educational Circular No. 336 (July 16, 1971) [hereinafter Educational Circular No. 336], reprinted in *House Hearings*, *supra* note 5, pt. 1, at 202-04. For an extensive discussion, see *Case Study of the Interpretation and Enforcement of the Net Capital Rule of the New York Stock Exchange* [hereinafter *Case Study*], in *Hearings on the Securities Industry Before the Subcomm. on Securities of the Senate Comm. on Banking, Housing and Urban Affairs*, 92d Cong., 2d Sess., pt. 4, at 215-359 (1972) [hereinafter *Senate Hearings*].

32. See HOUSE REPORT, *supra* note 4, at 27. See also *Case Study*, *supra* note 31, at 258-60.

33. 17 C.F.R. § 240.15c3-1(c)(7) (1973).

34. 17 C.F.R. § 240.15c3-1(c)(1) (1973).

35. For an extensive discussion, as well as a chronology of the events leading to the change in the NYSE's interpretation of its rule, see *House Hearings*, *supra* note 5, pt. 2, at 859-66; *Case Study*, *supra* note 31, at 263-65; SEC UNSAFE AND UNSOUND PRACTICES STUDY, *supra* note 10, at 103.

36. See HOUSE REPORT, *supra* note 4, at 29-30.

37. See Educational Circular No. 336, *supra* note 31.

mittee called for the adoption by the SEC of a single net capital rule applicable to all broker-dealers, whether their firms are conducted as corporations or as partnerships. The subcommittee also set forth several substantive elements of the proposed uniform SEC rule: (1) restrictions on the activities of broker-dealers when their capital position becomes tenuous, (2) a requirement that a promissory note, in order to receive capital credit, must impose liability on the promisor (a prohibition on non-recourse notes), (3) a percentage limitation on the use of subordinated accounts, (4) more sophisticated techniques for gauging the effect of fluctuations in security values, (5) prohibitions on excessive concentration of invested capital in the securities of any one issuer, (6) restrictions on the right to withdraw capital if a firm is in or is approaching financial difficulty, and (7) a requirement that a specified percentage of net capital take the form of equity rather than debt (a limitation on the use of subordinated accounts of non-owners of a broker-dealer in computing its net capital).<sup>38</sup> In at least partial response to these recommendations, the SEC has proposed a revision of its rule to eliminate the exemption for exchange member firms.<sup>39</sup> If the SEC proposal is adopted, the only further legislative change needed would be to remove from the SEC the power to continue to grant exemptions from its rule. A single net capital rule could be flexible enough to accommodate the differing requirements of various types of broker-dealers, including those primarily engaged in selling shares of investment companies, those engaged in retail brokerage, and those specializing in brokerage for institutional accounts. Although the exchanges and the National Association of Securities Dealers (NASD) would be permitted to adopt their own rules to supplement the SEC's rule, the latter would remain applicable to all firms, thereby establishing minimum financial standards.

B. *Restrictions on Use of Customers' Credit Balances  
and Securities*

As has been previously pointed out,<sup>40</sup> broker-dealers have in the past derived substantial portions of their working capital from the

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38. See HOUSE REPORT, *supra* note 4, at 31-35. The Senate subcommittee saw no need for legislation in these respects in view of the SEC's proposed uniform net capital rule. See SENATE REPORT, *supra* note 4, at 39. Legislation implementing the House subcommittee's recommendations can be found in H.R. 5050, 93d Cong., 1st Sess. § 304 (1973).

39. See SEC Securities Exchange Act Release No. 9891, *supra* note 29. The proposal would not prevent an exchange from imposing stricter requirements than those mandated by the rule.

40. See text accompanying note 19 *supra*.

use of their customers' credit balances and excess margin and fully paid securities. Although segregation of customers' fully paid and excess margin securities from those securities owned by the firm itself has been required by the rules of the NYSE and the NASD,<sup>41</sup> questionable segregation procedures, which give little, if any, protection to customers against misuse of their property, have developed in recent years. For example, in so-called "one-box" segregation, customers' securities are commingled with those of the broker, and the segregation is effected solely by bookkeeping entry.<sup>42</sup> To call this "segregation" is to resort to a fiction. In "bulk" segregation, the securities of all customers are kept in one location and arranged alphabetically by issuer. Although this method does achieve physical segregation of the broker-dealer's securities from those of his customers, identification of the ownership interests of particular customers is still dependent on accounting entries.<sup>43</sup>

Although section 8(c) of the Securities Exchange Act of 1934<sup>44</sup> authorizes the SEC to promulgate rules to prevent the hypothecation of securities to the detriment of customers, the provision has several loopholes. The statute permits a broker-dealer to pledge a customer's securities up to any amount as long as the total amount pledged does not exceed the total amount owed to the broker-dealer by *all* his customers.<sup>45</sup> Furthermore, the broker-dealer may loan (rather than pledge) his customer's securities up to any amount if the customer's consent has been obtained.<sup>46</sup> Such "consents" are generally obtained on standard forms as a routine matter.<sup>47</sup> If securities are pledged by brokers, the lender customarily advances only a portion of the fair market value of the securities used to secure the loan, but by lending the securities to another broker, a broker may obtain their full value.<sup>48</sup> Consequently, loans by brokers of their customers' securities represent a substantial source of working capital.<sup>49</sup>

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41. NYSE Rule 402.10, 2 CCH NYSE GUIDE ¶ 2402 (1957). See also NASD Rules of Fair Practice, art. III, § 19(d), CCH NASD MANUAL ¶ 2169 (1967).

42. See *House Hearings*, *supra* note 5, pt. 2, at 966-67.

43. See *HOUSE REPORT*, *supra* note 4, at 40.

44. 15 U.S.C. § 78h(c) (1970).

45. 15 U.S.C. § 78h(c) (1970). See also *House Hearings*, *supra* note 5, pt. 2, at 960.

46. Securities Exchange Act of 1934, § 8(d), 15 U.S.C. § 78h(d) (1970). See also *House Hearings*, *supra* note 5, pt. 2, at 960.

47. For a typical consent form, see *House Hearings*, *supra* note 5, pt. 2, at 961.

48. *Id.* at 960-63. See also H. BARUCH, *supra* note 10, at 38.

49. See SEC UNSAFE AND UNSOUND PRACTICES STUDY, *supra* note 10, at 135-38, indicating that substantial amounts of customers' fully paid securities were "loaned in error" during the period 1968-1970. The same may be said for securities "pledged in error." See *id.* at 131-35.

Although in theory the rules of the exchanges and the NASD restricted broker-dealers in their ability to take advantage of these loopholes, these rules were so loosely drawn or loosely enforced as to be ineffective during the period of financial crisis.<sup>50</sup> Consequently, under the 1970 amendments to the Securities Exchange Act of 1934 the SEC was directed to promulgate rules that "shall require the maintenance of reserves with respect to customers' deposits or credit balances" and was given authority to promulgate rules relating to "the acceptance of custody and use of customers' securities."<sup>51</sup>

The SEC did not promulgate a rule to deal with this complex problem until nearly two years after its authority had been increased. Although the rule, as eventually adopted,<sup>52</sup> required the maintenance of reserves with respect to customers' cash and cash realized through the use of customers' securities,<sup>53</sup> it did not require the segregation of fully paid and excess margin securities from other securities in the broker-dealer's possession, but merely prescribed that a broker-dealer must obtain "physical possession or control" of such securities within specified time periods.<sup>54</sup> "Physical possession or control" was so defined that segregation practices currently used by the industry could be continued.<sup>55</sup> The rule did, however, specify that securities held in a broker-dealer's "physical possession or control" would constitute "specifically identifiable property" for purposes of customers' claims against broker-dealers in the event of insolvency, thus confirming the priority of customers' claims under the Securities Investor Protection Corporation (SIPC) legislation.<sup>56</sup>

Although the SEC rule constitutes an improvement over the pre-existing pattern, further progress along these lines is possible. The House subcommittee suggested that "over the longer term, when the securities industry is sufficiently well capitalized to permit such a move . . . customers' funds should be protected by a complete

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50. *E.g.*, NYSE Rule 402 and NASD Rules of Fair Practice, art. III, *supra* note 41. These rules prohibit a firm from lending or hypothecating more securities carried for a customer's account than is "fair and reasonable" in the light of the indebtedness of the customer on such securities. "Reasonableness" is defined as 140 per cent of the customer's debit balance in the case of hypothecation and 100 per cent of such debit balance in the case of loans. *See House Hearings, supra* note 5, pt. 2, at 962-63.

51. Securities Investor Protection Act of 1970, § 7(d), Pub. L. No. 91-598, 84 Stat. 1653, *amending* 15 U.S.C. § 78o(c)(3) (1970).

52. 17 C.F.R. § 240.15c3-3 (1973).

53. 17 C.F.R. §§ 240.15c3-3(e), 240.15c3-3(a) (1973).

54. *See* 17 C.F.R. §§ 240.15c3-3(b) to (d) (1973).

55. *See* 17 C.F.R. § 240.15c3-3(c) (1973).

56. 17 C.F.R. § 240.15c3-3(j) (1973). For a discussion of this aspect of the rule and its relationship to the bankruptcy laws, *see* HOUSE REPORT, *supra* note 4, at 45. *See also* SPECIAL STUDY, *supra* note 1, pt. 1, at 410-14.

escrow arrangement. Legislation, if needed, could be patterned after the Commodity Exchange Act of 1936, which specifically requires a 100-percent segregation of customers' credit balances from the funds of the brokerage operation."<sup>57</sup> The subcommittee recognized that, although complete segregation of customers' funds might be desirable, there are serious practical difficulties in requiring segregation of customers' securities.<sup>58</sup> Nonetheless, if it becomes apparent that the SEC's rule does not provide sufficient protection for customers, it is likely that the subcommittee will either demand that the SEC tighten its definition of physical possession or control or propose legislation to achieve the same result.

### C. Greater Uniformity in Clearance and Settlement Procedures

Clearance and settlement is the process that completes a transaction, once its price and other terms have been agreed upon by the parties, either on the floor of a securities exchange or by telephone or other communication between broker-dealers in the over-the-counter market.<sup>59</sup> Each major securities exchange has its own clearance and settlement procedures, and a specified procedure is also prescribed by the NASD for the over-the-counter market.<sup>60</sup> Although appropriate functional differences in clearance and settlement facilities may be justified by differing market characteristics and needs,<sup>61</sup> functional differences should not be perpetuated if their persistence is due merely to historical reasons. In view of the likelihood that clearance and settlement facilities will be automated in the near future, the overriding consideration should be to insure that the systems interface with one another.<sup>62</sup>

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57. HOUSE REPORT, *supra* note 4, at 43.

58. *Id.* at 44. The practical problems arise largely from the increasing use by broker-dealers of central certificate depositories, where securities are held for a broker's account in the name of a nominee and are frequently in the form of "jumbo" certificates, which may embrace the securities of several customers. Also, the quantity of securities required for segregation is continually changing with purchases and sales, money receipts and disbursements, and changes in the market value of securities in customers' margin accounts.

59. For a general description of the process, see North American Rockwell Information Systems Co., *supra* note 6, at 10-15, reprinted at 2066-71.

60. For a description of the two primary methods of effecting clearance (the "daily balance order" method and the "continuous net settlement" method), see HOUSE REPORT, *supra* note 4, at 61-62. Recently, the NYSE, the AMEX, and the NASD have been discussing the creation of a national securities clearing system, which would entail, among other things, conversion of the AMEX and the NYSE clearing systems from a daily balance order method to continuous net settlement. See Wall St. J., Oct. 1, 1973, at 4, col. 3 (midwest ed.); *id.*, Oct. 5, 1973, at 4, col. 2.

61. See House Hearings, *supra* note 5, pt. 3, at 1341 (statement of Richard B. Howland, executive vice-president, New York Stock Exchange, Inc.).

62. Today, a large firm has to interface with as many as 15 different systems in its



There should also be greater uniformity in the regulation of clearance and settlement procedures, with over-all supervision of the regulatory framework vested in one organization. Theoretically, there are several ways to achieve such uniformity. First, clearance and settlement procedures could be centralized in one industry-owned facility, perhaps through a merger of the clearing corporations now operated by the securities exchanges with the National Clearing Corporation, operated by the NASD. Although this possibility may have a certain appeal, it entails all the risks and disadvantages of any monopoly. The advantages of centralization might be counterbalanced by restrictive practices and other abuses. Also there is the possibility that, with the passage of time, further innovation and creative change will be impeded. Second, centralization might be achieved by vesting all clearance and settlement procedures in a quasi-governmental corporation, similar to the Communications Satellite Corporation (COMSAT).<sup>63</sup> This alternative involves the same problems of monopolization as the first suggestion. In addition, without a clear showing that the regulatory job cannot be done by an existing agency, needless proliferation of entities, governmental or otherwise, should be avoided.

Third, the industry could be permitted a certain measure of pluralism, retaining existing systems, but with a greater degree of coordination and uniformity of regulation. This might be achieved by broadening the SEC's supervisory powers to include clearance, settlement, depositories, transfer agents, and registrars. Such an approach was suggested by the SEC, and, although the SEC expressly disclaimed any desire to extend its authority over the banking industry,<sup>64</sup> resistance to increased regulation in any form rapidly developed in banking circles.<sup>65</sup>

Early drafts of the bill to implement the SEC's recommendations centralized both rule-making and enforcement powers in the SEC, but the SEC's final draft, introduced in both the Senate and the House of Representatives, gave the SEC power to set standards for depositories and transfer agents while distributing enforcement of

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daily operations. *Hearings on S. 3412, S. 3297, and S. 2551 Before the Subcomm. on Securities of the Senate Comm. on Banking, Housing and Urban Affairs*, 92d Cong., 2d Sess. 139 (1972) (statement of Robert M. Gardiner, chairman of the board, Securities Industry Association).

63. See *House Hearings*, *supra* note 5, at pt. 3, 1377-80 (statement of Junius W. Peake, general partner, Shields & Co.). See also *id.* at 1444-47.

64. SEC UNSAFE AND UNSOUND PRACTICES STUDY, *supra* note 10, at 6.

65. See generally BNA SEC. REG. & L. REP. No. 176, at B-1 to -4 (Nov. 8, 1972). See also text accompanying note 71 *infra*.

the rules between the SEC and the federal and state bank regulatory authorities.<sup>66</sup> A bill carrying out this scheme passed the Senate in the late summer of 1972.<sup>67</sup> In the House Subcommittee on Commerce and Finance there was some initial skepticism about the desirability of distributing enforcement powers over bank transfer agents and depositories among federal and state banking authorities.<sup>68</sup> Eventually, however, the House subcommittee reported out a measure dividing authority between the SEC and the banking authorities, but also giving the SEC authority to inspect bank transfer agents.<sup>69</sup> Under this formulation, any dispute between the SEC and the banking authorities as to the appropriate method of regulating and enforcing rules relating to bank transfer agents would ultimately be decided by the SEC. The bill passed the House of Representatives on October 13, 1972.<sup>70</sup> A compromise measure died on the floor of the Senate under the threat of a filibuster shortly before Congress adjourned. Although there were rumors that the bill's defeat in the Senate was due to pressures from the banking industry,<sup>71</sup> this was never confirmed. It is hazardous to predict Congress' next step. A bill similar to the 1972 measure passed the Senate on August 1, 1973.<sup>72</sup> Renewed efforts by the House subcommittee to toughen the legislation, even if successful in the House, may meet substantial resistance in the Senate, and a compromise of some type will eventually have to be reached. Meanwhile, the SEC lacks sufficient authority to proceed with further regulation in the area, and the industry must at least temporarily forego the estimated 400 to 700 million dollars in savings<sup>73</sup> that would have resulted from the legislation, had it become law.

The Senate and House subcommittees do appear to agree that the stock certificate itself should eventually be eliminated as a

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66. See S. 3412, 92d Cong., 2d Sess. (1972); H.R. 14567, 92d Cong., 2d Sess. (1972).

67. S. 3876, passed by the Senate, Aug. 4, 1972, in 118 CONG. REC. S12785 (daily ed. Aug. 4, 1972).

68. See *Hearings on H.R. 14567, H.R. 14826 and S. 3876 Before the Subcomm. on Commerce and Finance of the House Comm. on Interstate and Foreign Commerce*, 92d Cong., 2d Sess. 133-35 (1972).

69. H.R. 16946, 92d Cong., 2d Sess. (1972).

70. 118 CONG. REC. H9936 (daily ed. Oct. 13, 1972).

71. BNA SEC. REG. & L. REP. No. 176, at B-4 (Nov. 8, 1972).

72. See S. 2058, passed by the Senate, Aug. 1, 1973, in 119 CONG. REC. S15421 (daily ed. Aug. 1, 1973). See generally *Hearings on S. 2058 Before the Subcomm. on Securities of the Senate Comm. on Banking, Housing and Urban Affairs*, 93d Cong., 1st Sess. (1973). The matter now lies at the disposal of the House of Representatives, which may delay action in this area until the comprehensive bill resulting from the House subcommittee's study (H.R. 5050, 93d Cong., 1st Sess. (1973)) is reported out of the full committee.

73. BNA SEC. REG. & L. REP. No. 176, at B-3 (Nov. 8, 1972).

means of settlement between broker-dealers.<sup>74</sup> Although the certificate is only part of the paperwork problem in processing trades, it is a central part, and its elimination would vastly simplify the transfer of ownership. Pending the elimination of the certificate itself, the flow of paper has already been substantially reduced through increased use of depositories and uniform forms for transfer, reclamation, delivery, and comparison.<sup>75</sup>

#### D. *Higher Standards for Entry into the Securities Business*

A study of the firms that failed during the 1967-1970 crisis indicated that, in many instances, failure might have been avoided if there had been stricter requirements for entry into the securities business. The examinations required for principals wishing to enter the business were too easily passed,<sup>76</sup> as were the examinations for

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74. SENATE REPORT, *supra* note 4, at 40 (setting a deadline of December 31, 1976); HOUSE REPORT, *supra* note 4, at 70. Both reports also advocated the elimination of state transfer taxes so as to exempt transactions occurring outside a state from such taxes where only the deposit into or withdrawal from a depository or transfer by bookkeeping entry takes place within that state. SENATE REPORT, *supra*, at 40; HOUSE REPORT, *supra*, at 74. Both subcommittees recommended the establishment of a National Commission on Uniform Securities Laws to assist the states in modernizing their laws to facilitate more efficient methods of transferring securities. SENATE REPORT, *supra*, at 41; HOUSE REPORT, *supra*, at 75. Both reports directed the SEC to study the practice of registering securities in a "street name" (registration under a "street name" occurs when a broker holds securities in his name, even though they are actually owned by his customers) to determine whether and what steps can be taken to facilitate communications between corporations and their shareholders, with particular reference to the problems presented by the holding of "street name" certificates in depositories. SENATE REPORT, *supra*, at 40; HOUSE REPORT, *supra*, at 73-74. The House Report also contained a recommendation directed to combining the functions of registrar and transfer agent. HOUSE REPORT, *supra*, at 73. For a bill incorporating these recommendations, see H.R. 5050, 93d Cong., 1st Sess. §§ 404, 406-08 (1973).

For a proposed amendment to the Model Business Corporation Act to facilitate direct communication between a corporation and beneficial owners where shares are held in "street name," see Sebring, *Proposed Changes in the Model Business Corporation Act*, 28 BUS. LAW. 329 (1973).

75. Uniform forms have now been adopted. See HOUSE REPORT, *supra* note 4, at 67 n.28. The Depository Trust Company (formerly known as the Central Certificate Service), organized by the NYSE, has now established regional depositories in more than ten states. BNA SEC. REG. & L. REP. No. 210, at A-13 (July 11, 1973); BNA SEC. REG. & L. REP. No. 187, at A-13 (Jan. 31, 1973). During 1972 alone a total of 160 billion dollars in shares were transferred by simple computer entry on the records of the Depository Trust Company. BNA SEC. REG. & L. REP. No. 191, at A-13 (Feb. 28, 1973). The Midwest Stock Exchange has also formed a depository trust company. BNA SEC. REG. & L. REP. No. 204, at A-11 (May 30, 1973). Although the Pacific Coast Stock Exchange has maintained a depository facility, recent financial problems incurred in operating it have resulted in a proposal to sell a 50 per cent interest in the depository to a consortium of four major California banks. Wall St. J., Aug. 2, 1973, at 2, col. 3 (midwest ed.). For a critique of the effectiveness of the depository system, see Comment, *Comprehensive Depository Systems and the Beneficial Owner*, 20 UCLA L. REV. 348 (1972).

76. See STAFF OF THE SPECIAL SUBCOMM. ON INVESTIGATIONS OF THE HOUSE COMM. ON INTERSTATE AND FOREIGN COMMERCE, 92D CONG., 1ST. SESS., REVIEW OF SEC RECORDS OF

those who wished to be registered representatives. This is another area in which the House subcommittee desired uniformity. Accordingly, it recommended that the SEC be given the clear authority and responsibility to develop a comprehensive broker-dealer examination program, including questions on bookkeeping, accounting, internal control of cash and securities, supervision of employees, maintenance of records, and general firm management.<sup>77</sup> Under these recommendations the SEC would be given similar authority to develop uniform minimum age and experience qualifications for principals, taking into account different classifications of broker-dealers.<sup>78</sup> As with the net capital rule, the SEC's requirements would establish minimum standards for all broker-dealers, and the exchanges or the NASD would be free to adopt stricter requirements.<sup>79</sup>

The House subcommittee also recommended (1) more frequent inspections of broker-dealers by the SEC or appropriate self-regulatory organizations, with mandatory inspections of newly registered broker-dealers within the first six months of their entry into business; (2) a requirement that certified financial statements accompany applications for registration as a broker-dealer; (3) broader statutory grounds for disqualification of applicants, including disqualification for conviction for serious criminal offenses, such as grand larceny; (4) a requirement of affirmative SEC action on applications for registration as a broker-dealer, to obviate the possibility that registration applications might become effective by default; and (5) confirmation of the SEC's power to refuse registration when a person in a control relationship to the applicant is the subject of pending disciplinary proceedings.<sup>80</sup>

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THE DEMISE OF SELECTED BROKER-DEALERS 23-26 (Comm. Print 1971) [hereinafter REVIEW OF SEC RECORDS]. See also *House Hearings*, *supra* note 5, pt. 1, at 125-28.

77. HOUSE REPORT, *supra* note 4, at 22.

78. *Id.* at 22-23. For a particularly distressing illustration of how a brokerage business can fail quickly when run by inexperienced persons, see REVIEW OF SEC RECORDS, *supra* note 76, at 110-18; *House Hearings*, *supra* note 5, pt. 1, at 124-25 (Broker-dealer registration was granted to a Harvard law student who had very limited experience in the brokerage business and "practically no knowledge of accounting." The firm compiled an extensive record of violations of the SEC bookkeeping requirements and also of the Federal Reserve Board's Regulation T (margin regulations) before becoming insolvent and being enjoined from conducting further business. At one time the registrant had bank overdrafts of 364,000 dollars, and, at the time of insolvency, it had in its possession 50,000 dollars or more in securities, the owners of which could not be identified.).

79. HOUSE REPORT, *supra* note 4, at 23.

80. *Id.* at 21-24. The last of these recommendations resulted from a finding that, pending an SEC investigation or disciplinary proceeding against a broker-dealer, it is "not uncommon" for the broker-dealer to form and register another entity. See SEC UNSAFE AND UNSOUND PRACTICES STUDY, *supra* note 10, at 163-64. Under such circumstances the SEC's only remedy is apparently to institute a separate proceeding against

In contrast to the House subcommittee's approach, the Senate subcommittee recommended that "only minimum necessary entry requirements" be imposed by federal statutes.<sup>81</sup> Although recognizing that the probability of failure is higher among newly formed firms with limited capital than among older, more experienced firms, the Senate subcommittee observed that "the failure of large, established firms . . . posed the greatest threat to customers and the industry" during the crisis period of 1968-1970.<sup>82</sup> It saw the "healthy injection of competition" provided by new entries into the brokerage business as "the best and most effective regulator of brokers and dealers."<sup>83</sup>

On closer inspection the recommendations of the House subcommittee are not inconsistent with the over-all objective of the Senate subcommittee to provide a "healthy injection of competition into the industry." The House subcommittee's concern was to ensure that competition was indeed healthy, supplied by well-managed firms staffed by qualified persons. Thus, the proposed reforms seem consonant with a goal of encouraging free, responsible entry into the brokerage business. This conclusion is reinforced by the recent decision of the NASD to form a committee to develop stricter entry requirements. The NASD has expressed its concern that sixty-three of the sixty-eight liquidations effected under the SIPC procedure during the past two years have involved NASD firms that were not members of any exchange. During the same period, an additional 109 NASD firms voluntarily ceased doing business. Some of the liquidations involved fraudulent practices. From the sixty-three firms liquidated by SIPC, eighty persons who served as principals are now back in business, and principals of some firms have been involved in more than one liquidation. Of the NASD members liquidated by SIPC, eighty-five per cent had been in business less than five years and had capitalization of less than 100,000 dollars.<sup>84</sup>

#### E. *Uniformity in Accounting and Auditing Procedures*

Although some changes are taking place in the accounting profession, there is still widespread dissatisfaction with the over-all lack

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the new entity, which might in turn lead to the formation of yet another registrant. See *Jaffee & Co. v. SEC*, 446 F.2d 387 (2d Cir. 1971). For several illustrative cases, see *REVIEW OF SEC RECORDS*, *supra* note 76, at 21-22. The House subcommittee implemented these recommendations in H.R. 5050, 93d Cong., 1st Sess. § 303 (1973).

81. SENATE REPORT, *supra* note 4, at 37.

82. *Id.*

83. *Id.*

84. See *Wall St. J.*, March 13, 1973, at 2, col. 3 (midwest ed.).

of uniformity in accounting standards. In this respect the brokerage community is not alone, although it also has some unique problems. Hearings held by the House subcommittee disclosed that two different accounting firms could reach different conclusions in the audit of one broker-dealer, although both firms might be following "generally accepted accounting principles."<sup>85</sup> The subcommittee recommended that the SEC require uniformity in accounting procedures, as well as in "accounting principles," no later than January 1, 1974.<sup>86</sup> Although exchange spokesmen argued that achieving such uniformity would be both costly and disruptive to broker-dealers,<sup>87</sup> the subcommittee concluded that lack of uniformity in procedures, if allowed to continue, would entail much higher costs in terms of potential customer losses and that any disruption resulting from a uniformity requirement would be justified by the improvements in financial reporting that would result.<sup>88</sup>

As to audit procedures, the House subcommittee recommended abandonment of the surprise audit in favor of regular annual or fiscal-year audits of broker-dealer firms.<sup>89</sup> Although surprise audits were thought to have some value if they reduce the opportunity for a broker-dealer to engage in transactions that improperly enhance its financial position at the audit date,<sup>90</sup> it was evident from the subcommittee's hearings that, particularly in the case of large broker-dealers with many customer accounts, firms frequently had several days' advance notice of an impending "surprise" audit.<sup>91</sup> In addition,

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85. *House Hearings*, *supra* note 5, pt. 2, at 1058-59. An example is provided by a case study of a NYSE member. The study, conducted by a NYSE examiner, indicated that, as of November 30, 1968, there were at least eight possible computations for the firm's net capital ratio, depending upon varying treatment given to such items as short stock differences, suspense accounts, and fails to deliver. *See REVIEW OF SEC RECORDS*, *supra* note 76, at 76-77.

86. *HOUSE REPORT*, *supra* note 4, at 49-50. Accounting "procedures" (in contrast to accounting "principles") "prescribe in a definitive manner how transactions and other events should be recorded, classified, summarized and presented and are the means for implementing . . . [accounting] principles." *Id.* at 49. Thus, implementation of uniform accounting procedures would entail prescribing a uniform system of accounts for all broker-dealers.

87. *See House Hearings*, *supra* note 5, pt. 2, at 997, 1010, 1025. Greater uniformity in reporting procedures (rather than in accounting procedures) was urged as an alternative approach. This would presumably entail uniform interpretations of the specific items required by the various report forms. *See, e.g., id.* at 1010 (statement of panelists from the NYSE), 1026 (statement of Andrew Barr, chief accountant, SEC).

88. *HOUSE REPORT*, *supra* note 4, at 50.

89. *Id.* at 54-55.

90. *See Wall St. J.*, Dec. 5, 1972, at 3, col. 2 (midwest ed.).

91. *See* Report from David Clurman, Assistant Attorney General, to the Attorney General of the State of New York, entitled *A Report on the Auditors of Wall Street* (undated), reprinted in *House Hearings*, *supra* note 5, pt. 2, at 1091, 1095-99.

since the very essence of a surprise audit is that it be made at irregular intervals, the procedure prevented comparisons of a firm's operating results from one year to another through income statements for comparable reporting periods. After receiving the House subcommittee's recommendations, the SEC did not object to the proposed abandonment of the surprise audit requirements by the Pacific Coast and Midwest Stock Exchanges.<sup>92</sup> The NYSE has proposed that surprise audits be made optional with its member firms, and the SEC has concurred in that proposal.<sup>93</sup> It is unlikely, however, that the House subcommittee will be satisfied with anything less than a complete elimination of the surprise audit. Thus, if the SEC fails to require this, legislation may be expected.

Among the other recommendations of the House subcommittee concerning accounting and auditing were (1) broadening the SEC's authority to require greater uniformity in reporting by broker-dealers, thus reducing the number and variety of reports and the paperwork involved in preparing them, (2) directing the SEC to broaden its rules relating to disclosure by broker-dealers of their financial condition to customers, and (3) reducing or eliminating redundancy in broker-dealer examination procedures, with one agency conducting such examinations, and the SEC establishing uniform guidelines and standards to minimize differences in rules, interpretations, and standards.<sup>94</sup>

### III. SELF-REGULATION

After the financial crisis of the late 1960's, there was a serious question whether the system of self-regulation under which the securities industry had traditionally operated was still viable. Certainly

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92. Wall Street J., Dec. 5, 1972, at 3, col. 2 (midwest ed.).

93. *Id.*; HOUSE REPORT, *supra* note 4, at 54 n.16. See also SEC Securities Exchange Act Release No. 10297 (July 25, 1973), 38 Fed. Reg. 20904 (1973), proposing amendments to SEC Rule 17a-5, 17 C.F.R. § 240.17a-5 (1973), and Form X-17A-5, 17 C.F.R. § 249.617 (1973), to permit independent public accountants "to perform audit procedures prior to the audit or balance sheet date of the broker or dealer." BNA SEC. REG. & L. REP. No. 213, at A-11, F-1 to -3 (Aug. 1, 1973). The change was prompted by the NYSE's proposal to eliminate the surprise audit requirement for its member firms. The SEC pointed out that "[t]o date all the major exchanges, with the exception of the NYSE and the AMEX have made the surprise audit requirement optional for their members." In proposing the change, the SEC pointed out that the independent accountant would not be precluded from performing procedures on a surprise basis when, in his judgment, they are appropriate. The SEC has now adopted the foregoing proposals. SEC Securities Exchange Act Release No. 10398. BNA SEC. REG. & L. REP. No. 220, at G-1 (Sept. 26, 1973).

94. HOUSE REPORT, *supra* note 4, at 50-57. For a recent SEC Advisory Committee report also recommending greater uniformity in reporting forms, see BNA SEC. REG. & L. REP. No. 182, at I-1 (Dec. 20, 1972).

the performance of the self-regulatory bodies in enforcing their rules in areas such as net capital, regulation of specialists, and the whole system of insuring broker-dealer financial stability by periodic examinations and uniform accounting principles and procedures left much to be desired.<sup>95</sup> An alternative to self-regulation might be some form of pervasive, direct federal control, through a drastic broadening of the powers of the SEC or other federal agencies. Both congressional subcommittees carefully considered the problem and concluded that, although self-regulation should be retained, it should be strengthened and made more responsive to the needs of the public.<sup>96</sup> Reforms that increased the number of "public" directors of the major stock exchanges to ten (out of a total of twenty-one directors)<sup>97</sup> are certainly consistent with the concept that the exchanges can no longer be considered to be private clubs that provide a trading monopoly to only a relative few.

But the House subcommittee was not content with recent reforms made by the exchanges. For example, it criticized the NYSE's failure to follow the recommendations of the Martin Report<sup>98</sup> as to the method of choosing public directors.<sup>99</sup> Under the Martin Report, the public directors, although initially chosen by a nominating committee of seven public representatives appointed by the Board of Governors (and then voted upon by the membership), would thereafter elect their successors in order to assure their continuing independence.<sup>100</sup> Under the proposals eventually adopted by the NYSE, the public, as well as other directors would continue to be elected by

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95. A particularly extensive examination of the effectiveness of self-regulation during the crisis period was conducted by the Senate Securities Industry Study. See *Case Study*, *supra* note 31; *Senate Hearings*, *supra* note 31, pt. 4, at 1-213. See also *HOUSE REPORT*, *supra* note 4, at 92-100.

96. See generally *HOUSE REPORT*, *supra* note 4, at 100-08. The House subcommittee suggested that the phrase "self-regulation" be replaced by the term "cooperative regulation," to describe more accurately the proper role of the exchanges and the NASD vis-à-vis the SEC and the Congress. See *HOUSE REPORT*, *supra* note 4, at 85. The term was first used in the Senate Report accompanying the Maloney Act. S. REP. NO. 1455, 75th Cong., 3d Sess. 3-4 (1938). The Senate subcommittee's most recent report conceded that the term "self-regulation" should be discarded if it is misleading, but it suggested that care be exercised "lest the use of phrases such as 'partnership' and 'cooperative regulation' lead to the impression that the industry and the government fulfill the same function in the regulatory framework or that they enjoy the same order of authority or deserve the same degree of deference, whether by firms, courts or the Congress." *SENATE REPORT*, *supra* note 4, at 147.

97. NYSE Const. art. II, 2 CCH NYSE GUIDE ¶ 1051 (1972); AMEX Const. art. II, § 1, 2 CCH AMEX GUIDE ¶ 9011 (1972).

98. See note 25 *supra*.

99. See *HOUSE REPORT*, *supra* note 4, at 106-07.

100. Martin Report, *supra* note 25, at 3196-97.



the Exchange membership.<sup>101</sup> This may cause the public directors to be less responsive to or representative of the public than they might have been under the Martin Report proposals.<sup>102</sup> In addition, Martin called for rather extensive reforms to align voting power on the Exchange more closely with the legal responsibilities and economic significance of member firms. Under his proposals each existing seat would be converted into ten shares, with one vote per share, but ten shares would be required to enable a firm to place a representative on the Exchange floor or to be a clearing member.<sup>103</sup> As far as voting power is concerned, share ownership would be limited in proportion to the amount of business done with the public.<sup>104</sup> These proposals were not carried out in the reforms that the Exchange actually adopted. Instead, certain Exchange members not actually owning their seats were required to give irrevocable proxies to their firms, the true owners of the seats.<sup>105</sup> As the House subcommittee pointed out, this did little to effectuate the more thoroughgoing reforms advocated by Mr. Martin.<sup>106</sup>

The House subcommittee also recommended that public directors be compensated adequately for the time and responsibility that they devote to their tasks and that they be given appropriate staff support, including independent counsel, independent accounting assistance, and, when necessary, independent technical assistance. This would substantially increase the efficiency and value of the contribution of public directors and would reinforce their independence.<sup>107</sup>

Although the Senate subcommittee did not recommend immediate endorsement of the Martin Report proposals concerning public directors and the reallocation of exchange seats, it did propose some relatively pervasive reforms in the procedures of self-regulatory organizations and in the powers and procedures of the SEC with respect to such organizations. First, although the Senate Report pointed out

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101. See NYSE Const. art. VII, § 10, 2 CCH NYSE GUIDE ¶ 1310 (1972).

102. See HOUSE REPORT, *supra* note 4, at 106-07. For an indication that the public directors of the NYSE may be lacking in independence, see Wall St. J., Aug. 30, 1972, at 27, col. 3 (eastern ed.) (replies from several public directors to a letter of inquiry from the president of the National Shareholders Association appeared to be identical in wording and, in three instances, were signed and sent by exchange staff members "on behalf" of the public directors concerned).

103. See Martin Report, *supra* note 25, at 3198-99.

104. *Id.* at 3200.

105. NYSE Const. art. VII, § 11, 2 CCH NYSE GUIDE ¶ 1311 (1972).

106. HOUSE REPORT, *supra* note 4, at 106.

107. *Id.* at 107. Essentially the same point was recently made by former Justice Arthur J. Goldberg when he resigned as a director of Trans World Airlines. See N.Y. Times, Oct. 29, 1972, § 3, at 3, cols. 2-3 (late city ed.).

For legislative implementation of the House subcommittee's recommendations, see H.R. 5050, 93d Cong., 1st Sess. §§ 202, 206 (1973).

that many of the major exchanges have recently revised their rules to ensure that disciplinary proceedings are conducted with a greater measure of fairness,<sup>108</sup> the Senate subcommittee recommended that the SEC be given authority to disapprove or modify exchange disciplinary procedures to assure continued compliance with due process standards.<sup>109</sup> In addition, the subcommittee endorsed the SEC's proposal that its review power over disciplinary proceedings, presently exercised only over NASD proceedings, be extended to include similar actions by exchanges.<sup>110</sup> Although the House subcommittee had also supported the SEC's suggestion that it be given power not only to review, but, in appropriate instances, to increase penalties imposed by exchanges in disciplinary proceedings,<sup>111</sup> the Senate subcommittee found little evidence of a present need for such additional SEC power. It pointed out that its investigations had not "disclosed serious problems with regard to self-regulatory agencies imposing inadequate penalties,"<sup>112</sup> and it also seemed impressed with testimony from industry leaders that to give the SEC power to increase penalties would weaken, rather than strengthen, self-regulatory disciplinary procedures.<sup>113</sup> Finally, the Senate subcommittee endorsed the recommendation of the SEC's Advisory Committee on Enforcement Policies and Practices<sup>114</sup> that self-regulatory disciplinary proceedings be open to public scrutiny through more adequate publicity of findings of violations, sanctions imposed, and standards on which decisions are based.<sup>115</sup>

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108. SENATE REPORT, *supra* note 4, at 152 & n.18.

109. *Id.* See also *id.* at 179. In a similar vein, the Senate subcommittee recommended amendments to the Securities Exchange Act that would impose procedural due process requirements on exchanges with regard to the denial of membership applications and impose on all self-regulatory organizations similar due process requirements relating to actions that might affect nonmembers. *Id.* at 154-55.

110. See SENATE REPORT, *supra* note 4, at 152, 179; SEC UNSAFE AND UNSOUND PRACTICES STUDY, *supra* note 10, at 7. The same proposal had previously been endorsed by the House subcommittee. See HOUSE REPORT, *supra* note 4, at 108-09. A bill was introduced in the House of Representatives in June 1972 at the SEC's request to achieve these objectives. See H.R. 15303, 92d Cong., 2d Sess. (1972). For the House subcommittee's views as to that legislation, see HOUSE REPORT, *supra* note 4, at 108-13.

111. See SEC UNSAFE AND UNSOUND PRACTICES STUDY, *supra* note 10, at 7; HOUSE REPORT, *supra* note 4, at 111.

112. SENATE REPORT, *supra* note 4, at 179.

113. *Id.* at 179-80, citing testimony in *Senate Hearings*, *supra* note 31, pt. 3, at 204, by the president of the American Stock Exchange, who said that giving the SEC power to increase penalties would tend to "fractionalize" responsibility and thus debilitate the self-regulatory process. This testimony was also relied on by the Senate subcommittee in rejecting the SEC's proposal that it be given power to enforce directly the rules of the self-regulatory bodies. See SENATE REPORT, *supra* note 4, at 178.

114. Securities & Exchange Commn., Report of the Advisory Committee on Enforcement Policies and Practices 60-61 (June 1, 1972).

115. SENATE REPORT, *supra* note 4, at 153.

Both subcommittees broadly supported the SEC's proposal to extend its authority over the adoption, alteration, or abrogation of rules by self-regulatory organizations.<sup>116</sup> Presently there are curious gaps in the extent of the SEC's powers over such organizations. For example, although the SEC has relatively broad powers over the licensing of exchanges,<sup>117</sup> its power to alter or supplement exchange rules is narrowly circumscribed as to subject matter, and the procedure for SEC modification of an exchange rule is relatively cumbersome.<sup>118</sup> Furthermore, although the SEC has by rule required exchanges to file reports of proposed rule changes, an exchange rule may be validly adopted notwithstanding a failure to file an appropriate report,<sup>119</sup> and, even when an exchange files a report of a proposed rule change, the SEC takes the position that it need not act affirmatively<sup>120</sup> but may merely indicate, often informally, that it has no objections to the proposed rule. As a result, the SEC may not learn of proposed rule changes by the exchanges in time to ensure an adequate review.<sup>121</sup> The often perfunctory review can present substantial difficulties for parties appealing the rule change in the courts, since the record of administrative review is sparse. Moreover, the SEC generally asserts that its failure to disapprove does not constitute an order; thus, its inaction is not subject to judicial scrutiny.<sup>122</sup> As a result of this inability to obtain direct review, exchange rules are frequently exposed to collateral attack in the courts

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116. *Id.* at 172-75; HOUSE REPORT, *supra* note 4, at 108-10.

117. See Securities Exchange Act of 1934, § 6, 15 U.S.C. § 78f (1970).

118. See Securities Exchange Act of 1934, § 19(b), 15 U.S.C. § 78s(b) (1970).

119. 17 C.F.R. § 240.17a-8(d) (1973).

120. See SENATE REPORT, *supra* note 4, at 199-200.

121. An example might be the manner in which the question of incorporating the NYSE was handled. See SENATE REPORT, *supra* note 4, at 172-74; *House Hearings, supra* note 5, pt. 3, at 1752-86.

122. For an extensive discussion, see SENATE REPORT, *supra* note 4, at 208-10. Only SEC "orders" are subject to review in the circuit courts of appeal under section 25(a) of the Securities Exchange Act. 15 U.S.C. § 78y(a) (1970). However, as the Senate report indicates, the federal district courts have additional powers to review SEC action under the Administrative Procedure Act. 5 U.S.C. §§ 702, 704 (1970). See *Independent Broker-Dealers' Trade Assn. v. SEC*, 442 F. 2d 132 (D.C. Cir. 1971), *cert. denied*, 404 U.S. 828 (1971). For cases illustrating the difficulty of obtaining review of SEC "non-disapproval" or inaction, see *Independent Investor Protective League v. SEC*, BNA SEC. REG. & L. REP. No. 131, at A-12 (2d Cir. 1971); *Project on Corporate Responsibility v. SEC*, [1972-1973 Transfer Binder] CCH FED. SEC. L. REP. ¶ 93,783 (D.C. Cir. 1972). The latter holding cast doubt on the continuing vitality of *Medical Comm. for Human Rights v. SEC*, 432 F.2d 659 (D.C. Cir. 1970), *vacated as moot*, 404 U.S. 403 (1972), which had held that the SEC's failure to object to a company's omission of a shareholder proposal under rule 14a-8 (17 C.F.R. § 240.14a-8 (1973)) was reviewable even though it was not technically in the form of an SEC "order." For additional discussion, see 3 L. Loss, *SECURITIES REGULATION* 1926 (2d ed. 1961).

under the antitrust laws.<sup>123</sup> Finally, changes in interpretations of exchange rules (as opposed to changes in the rules themselves) are entirely free from SEC scrutiny. Indeed, a substantial change in the effect of a rule can be implemented under the guise of an interpretation without the SEC's knowledge (much less its "non-disapproval").<sup>124</sup>

The same problems exist, to a somewhat lesser extent, in regard to SEC power over the rules of the NASD. Although the Securities Exchange Act requires the NASD to file copies of changes in, or additions to, rules with the SEC, such changes take effect automatically thirty days after filing unless the SEC enters an order disapproving the change or addition.<sup>125</sup> The SEC is required to disapprove the change or addition if it is inconsistent with the statutory prerequisites for registration of a national securities association.<sup>126</sup> As already mentioned, a rule may undergo a covert change through the guise of a new interpretation without triggering the filing requirements. Finally, the SEC's power to alter or supplement rules of a national securities association is confined by statute to relatively procedural matters,<sup>127</sup> although it does have the power to abrogate such rules entirely if this is necessary to ensure fair dealing and to protect investors.<sup>128</sup>

To ensure that the SEC would have enough information for an adequate review of rule changes under its expanded powers, the Senate subcommittee advocated a statutory requirement that self-regulatory organizations file with any proposed change a "concise general statement of its basis and purpose."<sup>129</sup> Although the subcommittee did not suggest that the SEC review procedure involve the formal adversary proceedings appropriate to the issuance of SEC orders, it did set forth minimum standards to be observed irrespective of the technical format of review:

[T]he new procedure should (1) provide interested persons the opportunity to present data, views, arguments, and rebuttal evidence

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123. See, e.g., *Silver v. NYSE*, 373 U.S. 341 (1963). See also SENATE REPORT, *supra* note 4, at 212-13.

124. See, e.g., text accompanying notes 32-35 *supra*.

125. Securities Exchange Act of 1934, § 15A(j), 15 U.S.C. § 78o-3(j) (1970).

126. Securities Exchange Act of 1934, § 15A(j), 15 U.S.C. § 78o-3(j) (1970). See also Securities Exchange Act of 1934, §§ 15A(b), (d), 15 U.S.C. §§ 78o-3(b), (d) (1970).

127. Securities Exchange Act of 1934, § 15A(k)(2), 15 U.S.C. § 78o-3(k)(2) (1970).

128. Securities Exchange Act of 1934, § 15A(k)(1), 15 U.S.C. § 78o-3(k)(1) (1970).

129. SENATE REPORT, *supra* note 4, at 156. See also *id.* at 201, 215-18. The subcommittee indicated that such statements should be similar to those required for rule-making under section 4(b) of the Administrative Procedure Act. See 5 U.S.C. § 553(b) (1970).

both orally and by written submission; (2) require the Commission to make specific findings and conclusions as to the necessity or appropriateness of the disapproval or alteration of the rule; (3) provide any person adversely affected a clear and expeditious means to obtain judicial review; and (4) require that the Commission's action be reversed if it is not supported by substantial evidence on the record taken as a whole.<sup>130</sup>

The House and Senate subcommittees differed with respect to the SEC's proposal to extend its authority to permit it to enforce the rules of self-regulatory organizations directly. Although the House subcommittee thought that the SEC might, by implication, already have direct enforcement authority with regard to self-regulatory rules, it agreed with "the utility of making the authority explicit."<sup>131</sup> The Senate subcommittee, on the other hand, found that deficiencies in the functioning of the self-regulatory system could be attributed more frequently to the SEC's failure to use its existing powers than to a lack of power to enforce self-regulatory rules directly.<sup>132</sup> In view of the possible adverse effects of further extensions of the SEC's powers,<sup>133</sup> the Senate subcommittee deferred any recommendation until receipt from the SEC of additional data as to specific "experienced needs" for such authority.<sup>134</sup>

The Senate subcommittee's case study of the SEC and exchange decisions involved in permitting members of the NYSE and Midwest Stock Exchange to engage in selling life insurance indicated the need for a clearer definition of the scope of exchange and NASD authority over their members and, in turn, of the scope of the SEC's obligations to supervise those self-regulatory organizations.<sup>135</sup> The SEC had sought to justify its relatively "passive and noncommittal atti-

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130. SENATE REPORT, *supra* note 4, at 176-77. The report also advocated that all comments and correspondence between the SEC and a self-regulatory organization concerning a proposed rule or rule change be made publicly available. Where fundamental policy issues are involved, public hearings or publicly announced conferences should be provided and the SEC should consider reviewing the particular proposal "on the record," thereby placing the burden of justification on the proponents of the rule and affording others significantly affected by the rule change the right to cross-examine and submit rebuttal evidence. *Id.* at 198-99.

131. HOUSE REPORT, *supra* note 4, at 111. For the legislative implementation of this recommendation, see H.R. 5050, 93d Cong., 1st Sess. §§ 208, 210 (1973). See also Dawidoff, *The Power of the Securities and Exchange Commission to Require Stock Exchanges to Discipline Members*, 41 FORDHAM L. REV. 549 (1973) (favoring the position taken by the House subcommittee).

132. SENATE REPORT, *supra* note 4, at 177-79.

133. *Id.* at 178. See note 113 *supra*.

134. SENATE REPORT, *supra* note 4, at 179.

135. See Staff Study of the Decisions Involved in Permitting Member Organizations of the New York and Midwest Stock Exchanges to Sell Life Insurance, in *Senate Hearings*, *supra* note 31, at 82-95.

tude" toward the question of life insurance sales by what it believed to be limitations on its regulatory authority contained in the McCarran-Ferguson Act of 1945.<sup>136</sup> Without seeking to decide whether the SEC was precluded from regulating broker-dealer sales of life insurance, the Senate subcommittee concluded that if the SEC has no regulatory authority in an area, the exchanges could have no power to authorize member activity in that area, for the powers of exchanges consist exclusively of those delegated to them by federal law.<sup>137</sup> To clarify the matter further, the subcommittee suggested that the Securities Exchange Act be amended to limit the scope of a self-regulatory organization's authority over its members to "securities related activities and to those aspects of their other activities, e.g., financial arrangements, which may pose dangers to public securities investors or to the public's confidence in the integrity of the securities markets."<sup>138</sup> Similarly, the Securities Exchange Act would be amended to "make explicit that the Commission's oversight authority encompasses all uses of self-regulatory power."<sup>139</sup>

Finally, viewing the distribution of regulatory power from a broader perspective, the Senate subcommittee advocated "a major rearrangement of the regulatory structure of the securities industry to meet the needs of the new central market system."<sup>140</sup> The chairman of the Securities Industry Association has similarly suggested that self-regulatory activities be restructured on the basis of function rather than firm membership, dividing self-regulation into two major areas: (1) regulation of trading and markets, and (2) regulation of firm and capital requirements.<sup>141</sup> Under the Senate subcommittee's proposal, the role of the exchanges would be narrowed somewhat to include primarily the regulation of member firms' activities in trading on exchanges or on any central market facility that might be developed. The NASD's regulatory role would be expanded to include all other activities of member firms in dealing with public customers, including selling practices, financial responsibility requirements, competence of personnel, and similar matters.<sup>142</sup>

The House subcommittee's report contained detailed recom-

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136. *Senate Hearings*, *supra* note 31, pt. 3, at 98 (testimony of SEC Commissioner Philip A. Loomis, Jr.). See 15 U.S.C. § 1012(b) (1970).

137. *SENATE REPORT*, *supra* note 4, at 162.

138. *Id.* at 163.

139. *Id.*

140. *Id.* at 168.

141. Address by Robert M. Gardiner, First Annual Conference, SIA Mid-Continental District 12-14, March 8, 1972, quoted in *SENATE REPORT*, *supra* note 4, at 167-68.

142. *SENATE REPORT*, *supra* note 4, at 168-69.

mendations aimed at strengthening the SEC's independence from the executive branch of the government and increasing its resources.<sup>143</sup> As a statutory creature, the SEC should be primarily accountable to Congress, not to the executive branch, although all five SEC commissioners are appointed by the President with the advice and consent of the Senate.<sup>144</sup> A primary area of Congressional control over the SEC has always been its power to review SEC budgetary requests, but that power has been hampered by directions that the SEC, along with other governmental agencies, submit its budgetary requests to the Office of Management and Budget (OMB) prior to passing them on to Congress.<sup>145</sup> Thus, Congress has generally seen budgetary requests only after they have been approved and, if need be, modified by the OMB; it does not see the submission originally made to the OMB by the SEC. This procedure not only deprives Congress of information that is useful in considering the budgetary needs of the SEC, but it is also inconsistent with the proposition that the SEC is, in a very real sense, an administrative branch of Congress and not part of the executive branch of the government.<sup>146</sup> Even though there may be a need to correlate the budgetary requests of the SEC and other independent regulatory agencies with those of the various executive departments, Congress should not be precluded from obtaining from the SEC all the information concerning its budgetary needs that the SEC submitted initially to the OMB. The House subcommittee has proposed that, whenever the SEC submits any budget estimate or request to the President or to the OMB, it shall concurrently transmit a copy of that estimate or request to Congress.<sup>147</sup>

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143. See HOUSE REPORT, *supra* note 4, at 114-15.

144. For a good discussion of the SEC's independence, see W. CARY, *POLITICS AND THE REGULATORY AGENCIES* 9-26 (1967), where it is noted that in addition to the potential threat of a Commissioner's removal, a substantial threat to SEC independence is the White House's control over budgetary policies. *Id.* at 12. See also 1 K. DAVIS, *ADMINISTRATIVE LAW TREATISE* § 1.03, at 21 n.17 (1958).

145. 31 U.S.C. §§ 23-24 (1970). See also *House Hearings, supra* note 5, pt. 3, at 1800-01.

146. Professor (former SEC Chairman) Cary has pointed out that the House Interstate and Foreign Commerce Committee takes its oversight responsibilities particularly seriously. This attitude is said to stem back to the view of former House Speaker Sam Rayburn who regarded the SEC as "one of his own progeny." W. CARY, *supra* note 144, at 104-05. In view of this it is not at all surprising that the current proposals to strengthen the independence of the SEC from the executive branch in these respects have originated from the House subcommittee rather than from its Senate counterpart.

147. See HOUSE REPORT, *supra* note 4, at 114; H.R. 5050, 93d Cong. 1st Sess. § 101 (1973). The House bill also provides that "any Commissioner may be removed by the President for neglect of duty or malfeasance in office, but for no other cause." H.R. 5050, 93d Cong., 1st Sess. § 101 (1973), *amending* Securities Exchange Act of 1934, § 4(a), 15 U.S.C. § 78d(a) (1970). In addition, once a Commissioner has been appointed to

In a similar vein, under questionable statutory authority the SEC and other such agencies have customarily been required to clear proposed legislation, and even proposed testimony by agency officials before congressional bodies, with the OMB prior to submission to Congress.<sup>148</sup> It is crucial that Congress receive testimony and legislative proposals directly from the SEC prior to their transmission to the OMB, the President, or any other official of the executive branch. Unlike budgetary considerations, SEC legislative proposals need not be correlated with similar requests by other governmental agencies. Indeed, the President's potential veto power over SEC legislative proposals and testimony (exercised through the OMB) constitutes a serious interference with the power and duty of Congress to exercise continuing oversight of the SEC and other independent regulatory agencies. The House subcommittee proposes to require the SEC to transmit to Congress all proposed legislation and all congressional testimony in advance of or simultaneously with submission of such material to the OMB.<sup>149</sup> The proposed requirement deprives any "officer or agency of the United States" of the power to require the SEC to submit legislative recommendations, testimony, or comments on legislation prior to submission to Congress.<sup>150</sup> If the SEC should voluntarily seek to obtain the comments or review of "any agency of the United States or of any other person," it shall "include a description of such actions in its legislative recommendations, testimony, or comments on legislation which it transmits to the Congress."<sup>151</sup>

Just as the OMB has acted as a screening device for SEC budgetary and legislative proposals, the Office of the Solicitor General has exercised a similar prerogative with respect to litigation that the SEC proposes to bring before the Supreme Court of the United States.<sup>152</sup> Although the Solicitor General has testified that this pro-

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serve as Chairman, he may not be demoted until the expiration of his term as Commissioner. If adopted this would remove another potential Presidential control over SEC Chairmen and Commissioners. For discussion of the removal and demotion powers under the existing statute, see W. CARY, *supra* note 144, at 9-10. As Professor Cary points out, the powers have been infrequently exercised but the potential exists as a threat to independence.

148. For an extensive discussion, see *House Hearings*, *supra* note 5, pt. 3, at 1800-09. For the OMB's asserted statutory basis for its jurisdiction in these respects, see *id.* at 1808-09. The House subcommittee concluded that "the requirement of Executive clearance has evolved without statutory basis." HOUSE REPORT, *supra* note 4, at 114.

149. HOUSE REPORT, *supra* note 4, at 114.

150. H.R. 5050, 93d Cong., 1st Sess. § 101 (1973).

151. H.R. 5050, 93d Cong., 1st Sess. § 101 (1973). See also H.R. 4036, 93d Cong., 1st Sess. (1973), which similarly clarifies congressional authority over all seven independent regulatory agencies, including the SEC.

152. See HOUSE REPORT, *supra* note 4, at 114-15.



cedure is not only proper, but crucial to the maintenance of the strength and stature of the government's posture in Supreme Court litigation,<sup>153</sup> there is a substantial risk that SEC views and arguments that happen to be unpopular with persons in the executive branch of the government may be screened out in advance. The SEC should be given the independence to conduct its own litigation before the Supreme Court, with the assistance, if need be, of the Solicitor General.<sup>154</sup>

Finally, the House subcommittee's proposed legislation contains a powerful mandate to prevent the SEC from transferring documents "in its possession or under its control to any other agency or to any person" without retaining copies of the material in question or imposing conditions that ensure that the material will be returned and submitted to Congress if requested.<sup>155</sup> This was added in response to an alleged attempt by the SEC to preclude various congressional committees from obtaining documents pertaining to an SEC investigation of the International Telephone and Telegraph Corporation. Allegedly at the suggestion of former Presidential Counsel John W. Dean, the SEC had transferred custody of the documents to the Justice Department.<sup>156</sup>

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153. See BNA SEC. REG. & L. REP. No. 206, at A-20 (June 13, 1973) (account of testimony of Erwin N. Griswold before the House Subcommittee on Commerce and Finance). The former Solicitor General testified that the effect of the House subcommittee's bill might be to cause the Court to take a more skeptical attitude towards SEC requests for judicial review. Under the present scheme, when judicial review in an SEC case is sought by the Solicitor General, the Court may have greater confidence that the case is one where Supreme Court review is appropriate. For a contrary argument, see *id.* at A-21 (testimony of Prof. Roy A. Schotland, who had acted as a special consultant to the House subcommittee in connection with the preparation of its recommendations and report).

154. HOUSE REPORT, *supra* note 4, at 114-15. Such a change is proposed in H.R. 5050, 93d Cong., 1st Sess. § 101 (1973).

155. H.R. 5050, 93d Cong., 1st Sess. § 101 (1973).

156. For an account of the ITT affair and the reaction of the House subcommittee, see N.Y. Times, June 7, 1973, at 1, cols. 2-3 (city ed.); Wall St. J., June 8, 1973, at 4, col. 2 (midwest ed.). As the latter report indicates, the incident drew the attention of Representative Harley O. Staggers, Chairman of the Interstate and Foreign Commerce Committee (parent to the House Subcommittee on Commerce and Finance). Representative Staggers, as Chairman of the House Special Subcommittee on Investigations, is conducting a further inquiry into the handling of the matter, as well as into broader areas pertaining to the SEC's enforcement of the securities laws. See BNA SEC. REG. & L. REP. No. 209, at A-12 (July 4, 1973). Interest in the ITT matter was heightened further by recent disclosures before the Senate Select Committee on Presidential Campaign Activities of a memorandum, written in March 1972 by Charles Colson, then special counsel to the President, to then White House Chief of Staff H. R. Haldeman urging the withdrawal of the nomination of Richard Kleindienst as Attorney General because of "the possibility of serious additional exposure" in the course of confirmation hearings then being conducted on Mr. Kleindienst by the Senate Judiciary Committee. The memorandum presumably outlined the existence of documents that would link high administration officials to the Justice Department's settlement in 1971 of its

## IV. CHANGES IN THE STRUCTURE OF THE MARKET

The problem of commission rates is at the center of the entire controversy about the desirability and form of a national or central market system and the qualifications for access to that system. Reduced to its simplest terms, the question is one of who is to pay the cost, and who is to receive the profits, of securities transactions. Institutional investors, who are responsible for an increasing percentage of dollar and share volume of trading on national securities markets,<sup>157</sup> have become unwilling to pay commissions that are disproportionate to the value of the services they receive. Institutions generally trade in relatively large blocks of stock,<sup>158</sup> but until recently the NYSE's commission rate structure did not provide for a wholesale rate for large transactions. For instance, until 1968, the commission rate charged by a broker-dealer for executing a transaction of 100,000 shares was 1,000 times greater than the commission on a round lot of 100 shares, even though the average cost of handling the larger order (assuming a trade in a stock selling for forty dollars per share) was only approximately 377 times as great.<sup>159</sup>

The response of institutions to this situation was to devise methods, some of them highly ingenious, to recoup part of the excessive commissions. Despite the NYSE's ban on rebates or discounts,<sup>160</sup> commission sharing between member firms was permitted; thus, a customer might instruct one member firm to give up part of its commission to another member firm. An institutional investor could thereby reimburse firms for valuable services, such as selling investment company shares or providing research services, unrelated

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action against ITT. See N.Y. Times, Aug. 3, 1973, at 1, col. 1 (city ed.); Wall St. J., Aug. 3, 1973, at 3, col. 2 (midwest ed.).

157. See note 4 *supra*.

158. See NYSE FACT BOOK, *supra* note 2, at 12.

159. 4 INSTITUTIONAL INVESTOR STUDY, *supra* note 2, at 2172. On December 5, 1968, a new NYSE rate schedule went into effect, containing, among other things, volume discounts. N.Y. Times, Dec. 4, 1968, at 65, col. 7 (late city ed.). See NYSE Const. art. XV, § 2, 2 CCH NYSE GUIDE ¶ 1702 (1973).

160. NYSE Const. art. XV, § 8, 2 CCH NYSE GUIDE ¶ 1707 (1972). There is a 40 per cent nonmember discount for certain firms. See NYSE Const. art. XV, § 2(h), 2 CCH NYSE GUIDE ¶ 1702 (1973); NYSE Rule 385, 2 CCH NYSE GUIDE ¶ 2385 (1973). Recently the NYSE has proposed to restrict this nonmember discount to business handled by brokers for "nonaffiliated" accounts. In practical terms, this would preclude a broker-dealer which is not a NYSE member from obtaining the 40 per cent discount for trades performed for institutional affiliates. See NYSE Educational Circular No. 419 (June 8, 1973), BNA SEC. REG. & L. REP. No. 206, at A-22 (June 13, 1973); NYSE Educational Circular No. 415 (June 1, 1973), BNA SEC. REG. & L. REP. No. 205, at K-1 (June 6, 1973). This interpretation was sharply criticized by Senator Williams in a letter to Acting SEC Chairman Owens. See BNA SEC. REG. & L. REP. No. 210, at A-11 (July 11, 1973).

to the trading transaction in question. In addition to these "give ups," complex reciprocal practices developed whereby, in exchange for business directed to NYSE member firms by institutional customers, those firms would refer unrelated business (business from other customers) to certain firms, designated by the institutional customers, which were members of one or more regional exchanges. These regional exchange members could thus be awarded commissions, through reciprocity at the direction of an institution, in return for other services, such as research or the sale of investment company shares.<sup>161</sup> Indeed, if the institution itself became a member of a regional exchange or purchased a membership for a wholly owned subsidiary, it could recoup commissions either directly or through reciprocal business.<sup>162</sup>

At the same time, trading volume was also increasing on the third market.<sup>163</sup> Institutions and other large customers might, at times, realize substantial savings by trading on a net basis with a third market maker, if the over-all cost of the transaction on a net basis were less than the cost of the same transaction on an exchange,

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161. 4 INSTITUTIONAL INVESTOR STUDY, *supra* note 2, at 2184-86. See also SPECIAL STUDY, *supra* note 1, pt. 2, at 302-27, 930. For an extensive description of the various forms of reciprocity, sometimes referred to as "four way tickets," "step outs," and "mirror trades," see *Hearings on S. 1164 and S. 3347 Before the Subcomm. on Securities of the Senate Comm. on Banking, Housing and Urban Affairs*, 92d Cong., 2d Sess., pt. 1, at 99-115 (1972). See also Welles, *The War Between the Big Board and the Regionals*, INSTITUTIONAL INVESTOR, Dec. 1970, at 21. For a more recent description of these practices, see Russo & Wang, *The Structure of the Securities Market—Past and Future*, 41 FORDHAM L. REV. 1, 13-15 (1972); Miller & Carlson, *Recapture of Brokerage Commissions by Mutual Funds*, 46 N.Y.U. L. REV. 35 (1971).

162. See *House Hearings*, *supra* note 5, pt. 8, at 4070. Cf. *Moses v. Burgin*, 445 F.2d 369 (1st Cir.), *cert. denied*, 404 U.S. 994 (1971) (mutual fund's investment advisor and its underwriter held liable in derivative action for failure to disclose to fund's unaffiliated directors the possibility of recapturing brokerage commissions by use of "give ups"). In SEC Securities Exchange Act Release No. 8746 (Nov. 10, 1969), [1969-1970 Transfer Binder] CCH FED. SEC. L. REP. ¶ 77,761, the SEC's General Counsel stated that "[w]e do not believe that management has [a fiduciary duty to purchase a seat on an exchange for an affiliated broker-dealer in order to recapture commissions] if in the exercise of its best business judgment management determines that it is not in the best interest of the fund to create such an affiliate." *Id.* However, if a fund does *in fact* acquire a seat on an exchange that permits recapture of commissions "there may be circumstances under which such recapture could be required and that the management may not be free to simply retain for itself revenues derived from this source." *Id.* Despite the SEC's view that there "may be circumstances" under which an investment adviser may have a duty to credit back the savings on commissions to the ultimate beneficiaries (*e.g.*, the shareholders of an investment company, through a reduction in the management fee charged by the investment adviser), the fact remains that under current law a broker-dealer may charge "the usual and customary broker's commission" for transactions effected by it on a national securities exchange on behalf of an affiliated investment company or investment adviser. See Investment Company Act of 1940, § 17(e)(2), 15 U.S.C. § 80a-17(e)(2) (1970).

163. See note 4 *supra*.

where a commission is added. Finally, institutions and others, by subscribing to automated intercommunications networks sometimes called the "fourth market," could trade directly with each other, bypassing the broker-dealer community entirely.<sup>164</sup> The effect of these practices was to create a demand for a further revision of the commission rate structure toward an eventual system of negotiated rates, to increase demands for a restructuring of the markets into a national, or central, market, and to stimulate institutional interest in obtaining exchange membership.

#### A. *Revision of the Commission Rate Structure*

Virtually all of the arguments against lower commission rates or negotiated rates are based on a few assumptions. First, it is assumed that relatively large brokerage firms operate more efficiently than smaller ones and are thus more likely to survive in a strongly competitive environment. This assumption lies behind the argument that the competition created by negotiated rates will lead to the demise of smaller, regional firms,<sup>165</sup> which in turn will adversely affect the ability of smaller, less nationally known corporations to raise capital.<sup>166</sup> This argument also assumes that regional securities firms rely on commissions from their brokerage business to subsidize their underwriting costs, rather than vice versa.

The second assumption is that negotiated rates will make agency brokerage unprofitable, thereby causing firms to do business as dealers rather than as agents,<sup>167</sup> and that firms will lose interest in exchange membership and choose to trade on a net basis in the third market.<sup>168</sup>

Third, it is assumed that negotiated rates, if they result in higher commissions for small investors, will discourage those investors from trading on the auction market, which depends for its vitality on a relatively large number of individual trades.<sup>169</sup>

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164. For a description of the fourth market, see *House Hearings*, *supra* note 5, pt. 7, at 3472-78.

165. HOUSE REPORT, *supra* note 4, at 135, citing *House Hearings*, *supra* note 5, pt. 6, at 2902-03, 2915-17, 3004-06, and pt. 7, at 3811-12.

166. *Hearings on S. 3169 Before the Subcomm. on Securities of the Senate Comm. on Banking, Housing and Urban Affairs*, 92d Cong., 2d Sess. 19-20 (1972) (testimony of SEC Chairman William J. Casey).

167. HOUSE REPORT, *supra* note 4, at 135, citing *House Hearings*, *supra* note 5, pt. 7, at 3726-27, 3811.

168. *House Hearings*, *supra* note 5, pt. 7, at 3811 (statement of American Stock Exchange). See also *id.* at 3741 (testimony of Robert W. Haack, president, New York Stock Exchange, Inc.).

169. HOUSE REPORT, *supra* note 4, at 135-36.

1. *Correlation Between the Size of Brokerage Firms and Their Efficiency and Profitability*

Few studies have been made in the area of firm efficiency, but the work that has been done suggests the absence of a correlation between efficiency and size. The April 1972 study by Friend and Blume indicated that there was

no support [for] the view that it is the small and regional firms which would be mainly affected by any decline in brokerage profitability, with possibly disastrous consequences for these firms and for sectors of the economy which they service. An analysis of the cost and profit structure of NYSE firms and of changes in the concentration of securities business over time leads to the conclusion that economies of scale in the brokerage business do not seem to be very strong, especially for regional firms.

The differences in efficiency among firms in a given size group seem to be larger than among the averages of firms of different size, once other relevant firm characteristics are held constant. The aftermath of competitive rates may be a reduction in the total number of NYSE firms, but our analysis suggests that such a reduction will be distributed over firms of all sizes. Indeed under competitive rates a number of the more efficient small and regional organizations may be able to compete more effectively for securities business and hence grow in importance.<sup>170</sup>

This conclusion is supported by earlier data obtained by an SEC staff economist in connection with the SEC's commission rate hearings commenced in 1968. A study of a cross-section of 330 NYSE member firms found that although some of the industry's largest firms are among the most efficient, so are many of its smallest firms. A total of seventy firms, forty of which were in the smallest size category (less than 2,700,000 dollars in annual commission income), were shown to have been more efficient than the industry leader, Merrill Lynch, Pierce, Fenner & Smith, Inc. The study also demonstrated that some of the industry's largest firms were among the least efficient.<sup>171</sup> Such data indicates that smaller or regional firms

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170. I. Friend & M. Blume, *The Consequences of Competitive Commissions on the New York Stock Exchange* (April 1972), reprinted in *House Hearings*, *supra* note 5, pt. 9, at 4404, 4444-45. For statistics regarding the relative lack of concentration in the brokerage business, see *SENATE REPORT*, *supra* note 4, at 54, which points out that the ten largest firms account for an aggregate of only 29.9 per cent of NYSE commission income, the twenty largest firms account for 43.9 per cent, and the fifty largest account for 62.2 per cent.

171. See *House Hearings*, *supra* note 5, pt. 8, at 4114-15, citing Garil Exhibit I, *Hearings on Commission Rate Structure Before the Securities & Exchange Commn.* (File No. 4-144).

In addition, see the tabular representation of profit margins of groups of NYSE member firms on commission business for the year 1971 contained in *SENATE REPORT*, *supra* note 4, at 53. The group containing the 34 clearing member firms having gross

will not be more adversely affected by negotiated rates than larger metropolitan firms.

Even in the case of firms that might be hurt, due to inefficiency or other factors, it does not follow that loss of commission income from agency business will adversely affect these firms' ability or incentive to participate in underwritings. Indeed, the House subcommittee found that "the distribution of new issues is the most lucrative part of the securities business and that some broker-dealers maintain their brokerage business in order to maintain a body of customers which enables the firm to secure underwritings."<sup>172</sup> These findings are supported by the Friend and Blume study, which concluded that "an analysis of the . . . brokerage business indicates that there is little prospect that securities firms would cut down on their underwriting activity simply because their commission revenues may have declined."<sup>173</sup>

## 2. *Effect of Negotiated Rates on Agency Brokerage Business*

At the outset, it is important to note that the prevailing markets on exchanges such as the NYSE are only in a qualified sense auction markets where brokers act as agents for their customers in competitive bidding. It has been estimated that in at least forty per cent of NYSE trading, a member firm is buying or selling for its own account.<sup>174</sup> With this qualification in mind, the question becomes whether the over-all effect of negotiated rates will be to lessen the tendency of broker-dealers to participate in trades on an agency basis and whether this, in turn, may have an adverse effect on the depth and liquidity of the markets as a whole. The question is not only complex but extremely difficult to answer in the abstract. Realistically, it also involves the question of whether, in a climate of fully negotiated rates, the broker-dealer community will be reluctant to price its services to yield a reasonable profit. There are at least two ways in which a broker-dealer may profit from a block trade. First, it may act as an agent and charge a commission for all or part of the trade commensurate with the effort, skill, and expense involved in its

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commission income in excess of 20 million dollars had an average profit margin of only 5.3 per cent. The average profit margin for all firms was 6.2 per cent, and the highest profit margin (10.5 per cent) was for the group of 18 medium-sized firms having gross commission income between three and four million dollars.

172. HOUSE REPORT, *supra* note 4, at 138. See also SENATE REPORT, *supra* note 4, at 55, 58-59.

173. I. Friend & M. Blume, *supra* note 170, at 4445.

174. House Hearings, *supra* note 5, pt. 6, at 3046 (testimony of Donald M. Feuerstein, counsel, Salomon Bros.). See also SENATE REPORT, *supra* note 4, at 106.

execution. Second, it may participate in the trade as a dealer and charge a net price that will reflect the same factors of effort, skill, and expense. There is little evidence that in a context of fully negotiated rates a broker-dealer would tend to choose one method in preference to the other.

Even if negotiated rates were to enhance the popularity of dealer trades, it does not necessarily follow that this result would be detrimental to the public interest. It has been argued that broker-dealers, deprived of the cushion of fixed minimum commissions, might widen their spreads on dealer transactions by purchasing securities at deeper discounts and selling them at higher premiums in order to compensate for the loss in commission income from agency trades. Such activity might increase the price volatility of shares, at least where substantial block trading is involved.<sup>175</sup> Although there is some evidence that this chain of events has occurred in large transactions where substantial parts of the trade are subject to negotiated commissions,<sup>176</sup> there is also evidence to the contrary. For example, the implementation of a quotation system for bid and asked prices of NYSE-listed securities on the NASD Automated Quotation System (NASDAQ), used in over-the-counter market trading, resulted in a narrowing of the spreads, presumably because improved information about the market enhanced the competition between market makers.<sup>177</sup> Indeed, the study by Friend and Blume concluded that "the reduction in commission rates associated with competitive pressures would probably not be offset by an increase in bid-ask spreads and might very well be reinforced by a decline in such spreads."<sup>178</sup> This would be particularly likely to happen if market makers were permitted to compete directly with specialists as part of a central market system and if information concerning bid and asked quotations were uniformly available to all members of the system.

Finally, it if became apparent that large transactions under a system of negotiated rates had unfavorable market impacts (an assumption contravened by the empirical data assembled by the SEC's Institutional Investor Study),<sup>179</sup> the problem could be dealt with

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175. *House Hearings*, *supra* note 5, pt. 8, at 4026-27 (testimony of Macrae Sykes, partner, Shields & Co.).

176. *Id.*

177. HOUSE REPORT, *supra* note 4, at 139; SENATE REPORT, *supra* note 4, at 117. For the Senate subcommittee's case study on the inclusion of NYSE-listed stocks in NASDAQ, see Examination of the Decisions Involved in the Inclusion of Listed Securities in NASDAQ, *Senate Hearings*, *supra* note 31, pt. 3, at 3-17.

178. I. Friend & M. Blume, *supra* note 170, at 4435. See also *id.* at 4431-33; SENATE REPORT, *supra* note 4, at 56-57.

179. See 1 INSTITUTIONAL INVESTOR STUDY, *supra* note 2, at XXI; 4 *id.* at 1462-65.

directly, rather than through perpetuation of fixed commission rates.<sup>180</sup> The SEC has indicated its willingness to explore various alternative approaches to the problem.<sup>181</sup>

### 3. *Effect of Negotiated Rates on Small Investors*

Even under a revised commission rate structure, for small investors (persons trading in units of 100 to 1,000 shares) it would probably be erroneous to refer to commissions as negotiated, since

180. HOUSE REPORT, *supra* note 4, at 139. The Senate report found "disturbing" the SEC's failure to study individual instances of institutional decision-making in the light of recent sharp drops in certain widely traded securities and directed the SEC to obtain "regular and comprehensive information regarding institutional transactions which contribute to unusual price movements," so as to be in a position to "impose or recommend appropriate restrictions if they are required." SENATE REPORT, *supra* note 4, at 114. For an account of sharp price fluctuations in one stock, see SENATE REPORT, *supra* note 4, at 109-10 (Occidental Petroleum, July 17-19, 1972). Trading of the shares on the NYSE was halted several times, but the regional exchanges and the third market were able to absorb much of the buying pressure.

181. See SEC Future Market Structure Statement, *supra* note 24, at 3450-51:

A wide range of approaches has been suggested. One type of proposal is directed at decreasing the volume of block trading by imposition of limitations on the ability of institutions to change positions, or of market makers and block positioners to assist institutions to change positions, rapidly in circumstances where the market impact is likely to be severe. Another type of proposal would accept the possibility of greater price gyrations from institutions' block trading and would focus on finding ways to enable the public to participate in the block premiums or discounts. A third type of modification would recognize the fundamentally different nature of block transactions, as distinguished from normal retail auction transactions and, with the aim of avoiding retail market price fluctuations, would accord them separate treatment. For example, blocks might be crossed and reported on a tape but not interfaced with the retail auction process; that is, limit orders on the specialist's book would not participate at all.

The foregoing proposals all raise very difficult questions and involve competing theories as to the kinds of markets that are most efficient and fair.

We would be reluctant to see any restriction on the liquidity of large blocks. Yet the cost of such liquidity may be greater price fluctuations. If greater price fluctuations, springing from the desire on the part of institutions to have instant liquidity, are to affect the value of individual holdings, directly or in pools, perhaps the public should have the opportunity to participate in resulting discounts and premiums. It also may be that requiring institutions to reflect the size of their holdings . . . in valuing their portfolios would result in a better balance between the propensity to accumulate large blocks and the expectation of instant liquidity. Better rules, procedures and incentives for positioning and redistributing large blocks may contribute to the resolution of these difficult problems.

Additional hearings focusing on the impact of institutional trading on the small investor are being held by the recently appointed Financial Markets Subcommittee of the Senate Finance Committee. See N.Y. Times, July 27, 1973, at 39, col. 7 (city ed.). See also N.Y. Times, July 31, 1973, at 50, col. 2 (late city ed.). In addition, Senator Harrison A. Williams, Jr., Chairman of the Subcommittee on Securities of the Senate Committee on Banking, Housing and Urban Affairs, introduced a bill (S. 2234, 93d Cong., 1st Sess. (1973)) on July 23, 1973, that would require institutional investors, such as banks, insurance companies, pension funds, and others having management authority over accounts valued at 10 million dollars or more, to disclose their portfolio holdings and any large transactions. See BNA SEC. REG. & L. REP. No. 212, at A-10, D-1 (July 25, 1973); Wall St. J., July 23, 1973, at 2, col. 3 (eastern ed.). The Senate subcommittee had previously advocated broader disclosure in this area. See SENATE REPORT, *supra* note 4, at 114. A similar recommendation had been made by the SEC's Institutional Investor Study. See 1 INSTITUTIONAL INVESTOR STUDY, *supra* note 2, at XI.



such investors generally do not have sufficient market power to negotiate in any real sense. Commissions on their trades might be termed competitive, in that firms would presumably compete for business by posting rates for small investors. The rates might reflect the cost of different services, such as simple execution of a trade, execution of trades accompanied by market advice (research), or custodial or other services. Rates reflecting separate charges for each service performed are generally referred to as "unbundled" rates.

It is probable that the initial effect of competitive rates will be to increase charges for small trades.<sup>182</sup> An increase may lessen investor incentive to trade, but if commissions adequately reflect the cost of transactions plus a reasonable profit, it is likely that broker-dealers will find small trades more appealing under a revised system than they are under the current rate system, and competition for the business of the small investor may increase. Such competition, particularly when coupled with the decreased processing costs that may result from greater uniformity and automation in clearance and settlement, may eventually reduce the cost of small trades and thus lower commissions.<sup>183</sup>

In any event, although increased commissions may discourage trading in small units, it by no means follows that investing (purchasing for long-term appreciation) will decrease. Although the small investor may choose to allocate his capital to an investment company or some other form of indirect ownership in order to save on commissions, it is just as likely that he will regard commissions as a relatively unimportant part of a transaction's cost when compared with its over-all price. A shift in emphasis from trading to investing by small investors would lead to a decrease in the average number of transactions during a given period. If, however, the cost of transactions were to decrease as a result of increased efficiency and centralization, investor interest in the market might increase, with greater numbers of small investors participating, even though on a long-term basis.

#### 4. *Effect of Negotiated Rates on Institutional Investors*

An associated problem is the possible effect of negotiated rates on institutional investors. Since, as stated, the "bundling" of various services into brokerage "packages" has enabled institutional investors and others to purchase research and related services through "soft"

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182. See I. Friend & M. Blume, *supra* note 170, at 4444.

183. As already indicated, the over-all savings that may result from a uniform system of clearance and settlement may amount to between 400 and 700 million dollars annually. See text accompanying note 73 *supra*.

commission dollars, it has been argued that an unfixed or competitive rate system will result in "unbundling," and institutions will be required to purchase research through "hard" dollars (in cash rather than in commissions). This may in turn create difficulties because of restrictions imposed by contract or state law on the level of fiduciary compensation,<sup>184</sup> thereby making it more difficult to absorb the cost of research purchased through "hard" dollars by increasing management fees. In addition, there are uncertainties as to the fiduciary duty of an institutional manager to "shop" a trade in order to insure its execution at the lowest possible commission rate despite the availability of valuable research services that might be obtained through a broker-dealer charging a somewhat higher rate.<sup>185</sup> To meet this concern, the Senate subcommittee has advocated amendments to the Investment Company Act and Investment Advisers Act that would clarify the ability of institutional managers to pay additional commissions for valuable research services.<sup>186</sup> This proposed legislation, coupled with the fact that research costs represent only a relatively small fraction (less than four per cent) of the operating expenses of brokerage firms,<sup>187</sup> should ensure that research in sufficient

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184. *House Hearings*, *supra* note 5, pt. 8, at 4262. See also SENATE REPORT, *supra* note 4, at 61.

185. See Delaware Management Co., SEC Securities Exchange Act Release No. 8128 July 19, 1967), [1966-1967 Transfer Binder] CCH FED. SEC. L. REP. ¶ 77,458, where a fund's investment adviser selected the broker offering a less favorable price because it provided the adviser with research, statistical services, and recommendations, as well as selling fund shares. The Commission held that, regardless of the value of the research or other services, an investment adviser is never justified in consummating a transaction at an inferior price. This position appears to have been modified by SEC Securities Exchange Act Release No. 9598 (May 9, 1972), 37 Fed. Reg. 9988 (1972), reprinted in *House Hearings*, *supra* note 5, pt. 8, at 4257-59, where the SEC stated that "an investment manager should have discretion, in assigning an execution or negotiating the commission to be paid therefor, to consider the full range and quality of a broker's services which benefit the account under management and need not solicit competitive bids on each transaction." It also added that "[t]he selection of a broker and the determination of the rate to be paid should, of course, never be influenced by the adviser's self-interest in any manner." *Id.* See also SENATE REPORT, *supra* note 4, at 61-62, which suggests that "many institutional managers, and legal advisors, have read too much into the SEC's decision in the *Delaware Management* case."

186. SENATE REPORT, *supra* note 4, at 62. A bill containing such amendments passed the Senate on June 18, 1973. S. 470, § 3, passed by the Senate, June 18, 1973, in 119 CONG. REC. S11366 (daily ed. June 18, 1973). Several witnesses before the House subcommittee advocated similar legislation. See *House Hearings*, *supra* note 5, pt. 8, at 3994, 4060 (testimony of Donald B. Marron, president, Mitchell, Hutchins & Co., Inc.), 4093, 4184 (testimony of Robert M. Gardiner). Mr. Marron also testified that, in his opinion, the effect of negotiated rates has been to decrease the number of brokers from whom an institution purchases research but also to upgrade the over-all quality of the research rendered. See *id.* at 4051.

187. See SENATE REPORT, *supra* note 4, at 60 n.95; *House Hearings*, *supra* note 5, pt. 8, at 4248 (testimony of Bernard H. Garil that research costs constitute about three per cent of broker-dealers' commission charges).

quantity and quality will continue to be available to the investment community, even if commission rates are competitive.

The House subcommittee has introduced legislation establishing a timetable for eliminating fixed commission rates. The breakpoint for negotiated rates would be reduced to 100,000 dollars by no later than February 1, 1974, and commission rates on all transactions would be negotiated or competitive after February 1, 1975, except that the SEC would be given power to extend the latter deadline by one year on a showing of public interest.<sup>188</sup> The Senate has passed a bill,<sup>189</sup> which, in contrast to the House subcommittee's measure, sets no fixed time schedule for phasing in fully competitive rates.<sup>190</sup> However, until rates are fully competitive, exchange members will be unrestricted as to the amount of brokerage they may perform for institutional affiliates or managed institutional accounts.<sup>191</sup> Presumably, the assumption is that the distaste of the brokerage industry for institutional membership, with its adverse effect on revenues of exchange member firms,<sup>192</sup> will lead the industry to adopt fully

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188. H.R. 5050, 93d Cong., 1st Sess. § 202 (1973).

189. S. 470 passed by the Senate, June 18, 1973, in 119 CONG. REC. S11366 (daily ed. June 18, 1973).

190. An earlier draft of the measure contained an April 30, 1974, deadline for eliminating fixed rates, subject to a one-year extension. Institutional affiliates who were exchange members prior to January 16, 1973, would have been given three years to phase out their affiliated business after the 1974 or 1975 deadline. However, industry pressures in favor of continuing fixed rates, particularly in view of the financial difficulties of brokerage firms in 1973, made it impossible for Senator Williams, the subcommittee chairman, to obtain the necessary votes to get the measure approved by the full committee. Thus, by an 11-4 vote in the full committee, a compromise was adopted whereby fixed rates could, at least theoretically, continue indefinitely, and yet the industry would be given an incentive to phase out fixed rates because, until that is done, exchange members are not subject to restrictions on the amount of brokerage that may be performed for an institutional affiliate or managed institutional account. Once fixed rates are eliminated, exchange members are given a two-year phase-in period to comply with the restrictions on institutional brokerage, a twenty per cent test applying during the first year and a ten per cent test applying during the second year, with a complete prohibition going into effect after the expiration of two years. See Wall St. J., May 17, 1973, at 2, col. 2 (midwest ed.). This approach may have been suggested by Robert I. Berdon, Treasurer of the State of Connecticut, who characterized his so-called "Connecticut compromise," made previously in a proposal to the SEC, as providing that "[t]he exchanges could move at their own pace with certain overall limitations, but during that time they have to allow institutional membership. This lets them set their own target date for eliminating the fixed commissions, down to zero." *Hearings on S. 470 and S. 488 Before the Subcomm. on Securities of the Senate Comm. on Banking, Housing and Urban Affairs*, 93d Cong., 1st Sess. 267 (1973) [hereinafter *Senate Hearings on S. 470*]. After the "compromise" was adopted by the full Senate committee, Senator Williams was quoted as saying that "the industry and its regulator know their goal is the elimination of fixed rates." See BNA SEC. REG. & L. REP. No. 202, at AA-2 (May 16, 1973).

191. See S. 470, passed by the Senate, June 18, 1973, in 119 CONG. REC. S11366 (daily ed. June 18, 1973).

192. See text accompanying notes 232-34 *infra*.

competitive rates, particularly if continuing pressure to do so is applied by the SEC. The assumption may be incorrect, and the effect of the Senate bill may be merely to legitimize the status quo.

Instead of moving toward competitive rates, the NYSE has apparently reconsidered its previous approval of the concept and has increased fixed rates for transactions not exceeding 300,000 dollars.<sup>193</sup> Although this purports to be merely a temporary expedient to resolve the financial difficulties of firms during the 1973 market slump, it drew sharp criticism from a congressional subcommittee chairman.<sup>194</sup> A poll conducted by the Securities Industry Association indicated that, out of a sampling of 183 firms, only one third favored increasing rates on orders of under 5,000 dollars, because of fears that such an increase would accelerate the small investor's exodus from the market.<sup>195</sup>

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193. The NYSE Board of Directors seemed at first to accept the concept of fully negotiated rates by mid-1974, provided that the third market be eliminated. *See* BNA SEC. REG. & L. REP. No. 192, at A-8 (March 7, 1973). Since the elimination of the third market would require legislation and both congressional subcommittees have indicated their belief that the third market should be retained, the NYSE position on the negotiated rate issue may be in doubt. In fact, the NYSE recently put into effect a schedule of increased commissions on large trades to alleviate current profit problems of its member firms. *Wall St. J.*, March 29, 1973, at 3, col. 2 (eastern ed.). NYSE Chairman Needham has been criticized for his frequent changes in position on the matter. *See* *Wall St. J.*, April 2, 1973, at 4, cols. 2-3 (eastern ed.), where one member firm executive was quoted as saying that "[h]e's had three positions in six months. . . . In October, he was for holding the line on negotiated rates to a \$300,000 cutoff. In February, he tells us we should go to fully negotiated rates. Now he's for raising fixed rates. The membership doesn't know where it's at."

The NYSE more recently increased commission rates on orders of 100 to 5,000 dollars by 10 per cent, with a 15 per cent increase in fixed commissions on orders between 5,000 and 300,000 dollars. In setting forth the proposed increase, the NYSE asserted that "fully competitive rates should be a long-term objective . . . [but that] the most urgent problem concerning the securities industry is the short term one of partially recovering recent cost increases." *Wall St. J.*, May 4, 1973, at 2, col. 3 (midwest ed.). A later proposal to impose a 0.4 per cent minimum commission charge on trades exceeding 300,000 dollars was subsequently abandoned. *See* *Wall St. J.*, June 8, 1973, at 4, col. 2 (midwest ed.). The SEC has acquiesced in the NYSE's proposed rate increase, but only on the condition that fixed commissions be abolished by April 30, 1975. In addition, pending the abolition of fixed commissions, broker-dealers would be permitted to charge commissions higher than the fixed rate (so as to permit recovery of costs of processing small trades, for example). Also, broker-dealers must be permitted "to provide less than a full range of brokerage services presently furnished customers in return for discounts of up to 10 per cent from the commission rate scheduled." Thus, a broker-dealer could charge a customer up to 10 per cent less for providing minimal services, such as execution and clearance. *N.Y. Times*, Sept. 12, 1973, at 1, col. 6 & at 71, cols. 2-3 (city ed.); *Wall St. J.*, Sept. 12, 1973, at 3, col. 1 (midwest ed.).

194. BNA SEC. REG. & L. REP. No. 204, at A-10 (May 30, 1973).

195. *See* *Wall St. J.*, May 10, 1973, at 4, col. 4 (midwest ed.); *N.Y. Times*, May 10, 1973, at 68, col. 1 (late city ed.). *See also* *N.Y. Times*, May 15, 1973, at 38, col. 1 (late city ed.) (critical editorial comment). Indeed, under the present fee schedule, which allows discounts for larger orders, a 10 per cent increase on a 100 share order may

At best, the NYSE's action is but a stopgap measure, and, from a broader perspective, it is regressive and against the long-term interests of the brokerage industry. Recent testimony before the Senate Subcommittee on Securities by Dr. William Freund, the NYSE's chief economist and vice president in charge of planning and research, indicated that an increase in fixed rates is not the answer to the rising cost of doing business in the brokerage industry. Indeed, Dr. Freund indicated that fixed commission rates "may intensify pressures on profit margins since minimum rates have, in effect, also become maximum rates in our industry."<sup>196</sup> The problem is also exacerbated by the phenomenon of "regulatory lag." Discussions between the industry and the SEC about increased commission rates began as early as 1968, but it was not until an emergency developed in 1970 that a fifteen dollar surcharge was approved. The rate schedule prevailing prior to the recent increase became effective in March 1972, but it was based on economic studies covering most of 1970. Thus, when adopted, the schedule was nearly two and a half years out of date and did not reflect the sharp inflation of the intervening period.<sup>197</sup> Even though the increase has now been approved by the SEC, economic conditions are likely to change rapidly once more.

The time has come to determine whether the brokerage business in this country is best run as a public utility, with administered prices for services, or whether *in its own best interests* (including the interests of the small investor whose participation it hopes to encourage) it would be more likely to flourish under a more flexible and realistic format of competitive rates.<sup>198</sup> As in its approach to the problem on back office paperwork, the brokerage industry has tended to cling to the past, seeking certainty and short-term solutions to its problems but finding only added expense and further confusion. The survival of a viable securities market requires not only centralization of the markets (an objective difficult or impossible to attain in a context of fixed commission rates)<sup>199</sup> and simplification of the paperwork in processing transactions, but also a more flexible method for brokerage firms to adjust charges for their services to

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amount to more money per 100 shares traded than a 15 per cent increase on trades of 1,000 shares or more. For the computation, see N.Y. Times, May 9, 1973, at 66, col. 3 (late city ed.).

196. *Senate Hearings on S. 470*, *supra* note 190, at 445.

197. *Id.* at 459.

198. See Wall St. J., July 30, 1973, at 11, col. 3 (midwest ed.) (statement of Sen. Harrison Williams, Jr., to SEC).

199. See text accompanying notes 158-64 *supra*.

yield a reasonable profit reflecting current costs and yield on invested capital. This can best be done through competition in commission rates. Rather than fearing competition, the securities industry should welcome it as a healthy solution to the present predicament.

### B. *Restructured Central Market System*

The phenomenon of fragmentation, or diversification, of the markets has led to suggestions that the markets be centralized and more closely coordinated with one another. The elimination of fixed commission rates will abolish a powerful disincentive to the development of a central market system, for the fragmentation of markets has in the past been largely attributable to the search by institutional investors for ways in which to save commission dollars.<sup>200</sup> At least two general problems, as well as many exceptionally difficult specific problems, are involved in centralization. It is important at the outset to inquire whether centralization of the markets is in the public interest, and, if so, what type of centralization is desirable. One must also consider specific obstacles to centralization and how they may best be overcome.

#### 1. *Advantages of Centralization*

The best way to approach this matter is to illustrate how fragmentation or diversification of the markets has operated to the detriment of investors. Suppose<sup>201</sup> investor *A* gives his broker an order to purchase one hundred shares of General Motors at the best available price (a market order). Suppose investor *B* tells his broker to sell one hundred shares of General Motors at seventy-five dollars or higher (a limit order). If both orders were represented on the floor of a single exchange, they would be directly matched. *A* would pay seventy-five dollars per share plus a minimum commission of approximately sixty cents per share. *B* would receive seventy-five dollars per share less a similar commission. Suppose, however, that *A*'s order to purchase is on the NYSE, and *B*'s order to sell is on the Pacific Coast Stock Exchange. In such case, the orders could not be directly matched. A dealer would have to purchase the one hundred shares from *B* on the Pacific Coast Stock Exchange and then sell them to *A* on the NYSE. Since the dealer would have to be compensated for performing this function, he would offer the buyer a price

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200. See text accompanying notes 161-64 *supra*. See also SENATE REPORT, *supra* note 4, at 49-51, 57-58.

201. This hypothetical situation is developed in more detail in *House Hearings*, *supra* note 5, pt. 6, at 2962-63 (statement of Donald M. Feuerstein).

higher than seventy-five dollars per share or offer the seller a price lower than seventy-five dollars per share (or split the loss between buyer and seller), thus adding to the over-all cost of the transaction. In addition, instead of a single transaction transferring ownership of the stock from *B* to *A*, there would be two transactions at different prices, which would inflate the volume in General Motors stock and create an additional price change. To complicate the matter even further, if the dealer interposed between *A* and *B* were not a member of the NYSE, he would have to sell the shares to a NYSE member or pay a commission to a NYSE member to act as his agent in selling the stock to *A* on the NYSE. The additional broker-dealer would, of course, take his profit from the transaction, further increasing its cost.

Moreover, these illustrations assume that the stock sold by the investor with the best offer eventually finds its way into the hands of the investor with the best bid. This would not necessarily be the case, for either *A*'s order or *B*'s order might be sent to the third market. NYSE member firms are by rule precluded from dealing with third market firms except under the most stringent conditions,<sup>202</sup> and, even if a transaction is executed in the third market, it would not, under present conditions, be publicly reported. Even if the bids and offers appear on stock exchanges there is no guarantee that the best bids and offers will be executed. Suppose a market order on the NYSE to purchase one hundred shares of General Motors, a limit order on the NYSE to sell one hundred shares at \$75.25, and a limit order on the Midwest Stock Exchange to sell one hundred shares at \$75. The one hundred shares would be executed on the NYSE at \$75.25, and the sell order on the Midwest Stock Exchange would go unexecuted. Whenever orders are not on the same stock exchange, the best public bid may fail to be matched with the best public offer. Indeed, there may be more than two or three contemporaneous orders in the same stock, and the stock may be traded on even more than three stock exchanges, as well as in the third market, thereby increasing the likelihood of unnecessary dealer transactions, missed executions, and misleading reporting of activity.

Supplementing these illustrations, one witness testified before the House subcommittee that stock was sometimes traded by institutions on regional exchanges solely for the purpose of recapturing commissions.<sup>203</sup> Although such a practice might result in a saving on the commission, the institution might end up paying more for the stock, or receiving less for it if it were a seller. Suppose, for example, an in-

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202. See NYSE Rule 394, 2 CCH NYSE GUIDE ¶ 2394 (1973).

203. *House Hearings*, *supra* note 5, pt. 8, at 4024-25 (testimony of Macrae Sykes).

stitutional seller offers sixty-five dollars for General Electric but insists that the transaction be executed on the PBW Stock Exchange (in order to recapture part of the commission). A NYSE member firm might refuse to enter into the transaction, but, later in the day, if the stock were selling at \$64.50 on the NYSE, the firm might bid \$64.50 for the institutional block on the PBW Stock Exchange, and the transaction might be executed there at that price. There would be no way to prove that, from the standpoint of the institutional seller, this was a poor execution because, at the time of the trade, the stock was selling for \$64.50 on the NYSE. However, the fact of the matter would be that the institution's insistence on recouping commission costs by selling only on the PBW Stock Exchange would have entailed a delay that caused it a loss of fifty cents per share.

Although trading on regional and other markets has at times had a beneficial effect in providing for greater competition in price and execution capability, as well as in providing further capital for absorbing relatively large blocks of stock and hence in increasing the depth and liquidity of the markets, there have been detrimental effects that probably counterbalance any benefits. Thus, as the House report pointed out:

The fixed minimum commission rate schedule has led to distortions in trading patterns. In deciding where, when, and with whom to execute transactions, brokers and institutional investors consider the uses they can make of the fixed minimum commission dollars, in addition to the paramount consideration of best net price. Because of the absence of any central quotation system, moreover, investors or their brokers have difficulty determining where they can receive the best net price. In addition, since transactions on the regional exchanges and in the third market are not reported nationally, investors have difficulty determining whether they have received best execution. Also, rules such as New York Stock Exchange rule 394 inhibit competition and, in some cases, prevent investors from getting the best price. These factors affect adversely the depth, breadth, and liquidity of the nation's securities markets.<sup>204</sup>

## 2. *Desirable Form of Centralization*

At the risk of oversimplification, the proposals for restructuring the market may be grouped into two main categories: (1) the one-exchange proposal, and (2) the federated-markets proposal.

The one-exchange proposal envisages one format for trading listed stocks and a separate format for trading nonlisted, over-the-counter stocks. Listed stocks would be traded on a single exchange, which might consist of several market centers in various geographical

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204. HOUSE REPORT, *supra* note 4, at 118-19.



locations throughout the country. The various market centers, or floors, would be subject to uniform regulation by a single self-regulatory authority. This could be accomplished through a merger of the present regional exchanges with the NYSE and the AMEX. This single exchange would be the exclusive means for trading listed stocks, although several types of listing might be provided, depending upon the characteristics and share distribution of different issues.<sup>205</sup> Over-the-counter trading in listed stocks would be prohibited; thus, the third market as it now exists would be eliminated. Presumably, the fourth market would continue to exist, so shareholders would still be permitted to trade directly among themselves.<sup>206</sup>

A market system similar to that suggested by the one-exchange proposal might be achieved without a merger of exchanges if the existing exchanges were subject to complete uniformity of rules, including uniform requirements of disclosure of trades and bid and asked prices, and if membership on one exchange entailed the right to execute trades on any other exchange without additional cost (except, perhaps, for the payment of floor brokerage charges when a member of the system executes trades for another member who does not have access to the physical facilities of the exchange floor where the trade takes place).<sup>207</sup> Under such a scheme the various exchanges would be left intact to administer their own trading facilities, but the third market would nonetheless be abolished.

The federated-markets proposal is more difficult to describe.

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205. See Martin Report, *supra* note 25, at 3194-95. Recently the NYSE's Board of Directors has voted to seek legislation to abolish the third market and to require that listed stocks be traded only on one or more registered national securities exchanges and under "substantially identical" rules. See BNA SEC. REG. & L. REP. No. 187, at A-11 (Jan. 31, 1973).

206. Elimination of the fourth market might entail imposing restrictions on the transfer of securities that traditionally have been thought to be against public policy, at least where shares are not closely held. See 2 F. O'NEAL, CLOSE CORPORATIONS §§ 7.06-.12 (1971 ed.); W. PAINTER, CORPORATE AND TAX ASPECTS OF CLOSELY HELD CORPORATIONS § 3.1 (1971). See also SENATE REPORT, *supra* note 4, at 121: "[R]estriction of trading in securities to a single market is a drastic measure, to be legislated only when the public interest clearly requires it. It is not a prerogative of corporate management, which has no legitimate interest in restricting the trading opportunities of investors who have acquired a company's shares." The SEC, in a policy statement relating to the proposed central market system stated that "initially" fourth market transactions would not be subject to the regulatory requirements imposed on those who trade within the central market system. However, "[s]hould the fourth market develop as a means to avoid the reporting and other obligations of trading within the system, the Commission will give prompt consideration to corrective measures, including recommending legislation if necessary, to bring such transactions within the scope of the system." Securities & Exchange Comm'n., Central Market System (March 29, 1973), reprinted in CCH FED. SEC. L. REP. No. 973, pt. 2, at 15-16 (April 2, 1973) [hereinafter SEC Market System Statement].

207. See HOUSE REPORT, *supra* note 4, at 123. See also SEC Market System Statement, *supra* note 206, at 48-55.

Essentially, it rejects the suggestion that the present exchanges should be merged with one another or subjected to a single self-regulatory body. It seeks to perpetuate the pluralistic format of today's markets but attempts to achieve the general objectives of a central market system by effecting reforms in three main areas: (1) greater uniformity of disclosure of transactions and bid and asked quotations in all markets through a consolidated tape and composite quotation system, (2) greater, although not necessarily complete, uniformity in regulation of the various markets, and (3) elimination of many of the existing barriers to competition between markets, in order to achieve, to the fullest extent possible, the advantages of a public auction market closely interrelated to a dealer market, with priority given, wherever possible, to public orders on the books of specialists and competing market makers.

The one-exchange proposal has the advantages of relative simplicity. Its main disadvantage is the monopoly that it would provide for those who control and belong to the central market. Not only would the regional exchanges be subsumed under one regulatory body, but the third market would be eliminated. The fundamental weakness in this approach is that no convincing case has been made for the proposition that the over-all objectives of a central market system can be achieved only through the creation of a monopoly. In view of our historic bias in favor of competition, the burden of proof should be on those who assert that a central market system cannot be attained except through the elimination of competition. There is a very real danger that any monopoly may eventually result in regulatory stagnation—a disinclination to experiment with innovative approaches to new problems as they arise. In the words of President Nixon's 1970 Economic Report:

The American experience with regulation, despite notable achievements, has had its disappointing aspects. Regulation has too often resulted in protection of the status quo. Entry is often blocked, prices are kept from falling, and the industry becomes inflexible and insensitive to new techniques and opportunities for progress.

There is no clear safeguard against these dangers, but more reliance on economic incentives and market mechanisms in regulated industries would be a step forward.<sup>208</sup>

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208. 1970 ECONOMIC REPORT OF THE PRESIDENT 107-08 (H. Doc. No. 253, 92d Cong., 1st Sess. (1970)). SEC Commissioner Loomis testified that to abolish the third market would be "contrary to the stated position of the Commission both in its statement of the future structure of the securities markets and earlier in its transmittal of the Institutional Investor report." *Senate Hearings, supra* note 31, pt. 3, at 229. Both congressional subcommittees have endorsed the SEC's position in this respect. *See SENATE REPORT, supra* note 4, at 96; *HOUSE REPORT, supra* note 4, at 121-23. *See also* N.Y. Times, March 16, 1973, at 55, col. 8 (late city ed.) (speech by former SEC Chairman G. Bradford Cook).

The federated-exchange concept has none of the disadvantages of a monopoly. Correspondingly, it seems better designed to ensure the continuing vitality of the regulatory structure through competition between market centers. On the other hand, unless there is considerable uniformity in regulation and coordination of disclosure, such a structure would entail some of the disadvantages of today's markets—failure to report transactions and to disclose (except on a limited basis) bid and asked quotations, together with what might be termed destructive competition in developing rules that favor particular groups.<sup>209</sup> Although innovation in developing new methods of executing, reporting, and processing transactions should not be discouraged, competition in other regulatory areas, such as restrictions on membership and prohibitions against certain types of short selling and other forms of manipulation, should be replaced by uniformity. In addition, existing barriers to competition between markets should be eliminated wherever possible and entry to the market system opened up to all who qualify under appropriate standards of financial and professional responsibility.

### 3. *Problems Associated with Centralization*

a. *Consolidated tape and composite quotation systems.* The over-all objective of composite reporting of transactions and bid and asked prices is to ensure that information on all trades, wherever they take place, is rapidly available throughout the system, and that all members of the system have access to information concerning bid and asked prices. Today trades are reported primarily through the separate tapes administered by the NYSE and AMEX, which report only trades taking place on their respective exchanges and hence do not report trades of dually listed stocks that take place on regional exchanges or trades in the third market. Similarly, bid and asked quotations on an exchange are available only to members of that exchange. Although recently the NYSE offered to disclose bid and asked quotations in its listed stocks to members of other exchanges, the proposal did not envisage disclosure of such quotations to third market makers.<sup>210</sup> It is apparent, then, that disclosure by the exchanges has been selective, and, since disclosure has been linked to exchange membership, insufficient disclosure has impeded competition between market centers.<sup>211</sup>

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209. Without uniform regulations, the various exchanges might compete with each other in relaxing their rules in order to attract a greater volume of trading. See HOUSE REPORT, *supra* note 4, at 129.

210. See *Senate Hearings*, *supra* note 31, pt. 3, at 226-29.

211. For one result of this lack of communication between market centers, see text following note 201 *supra*.

On March 8, 1972, the SEC proposed two rules that would require exchanges and market makers to provide on a current basis to "vendors of market information" reports of all transactions in listed securities and quotations of specialists and third market makers in such securities.<sup>212</sup> Subsequently, an SEC advisory committee recommended a system by which trades would be reported through tapes or interrogation display devices in two separate streams of data, one consisting of trades of all stocks listed on the NYSE and the other consisting of trades of all other listed stocks. In addition, the transaction reports would indicate the market in which the trade was effected "until regulation in all markets is appropriately equal for the protection of the public interest."<sup>213</sup> Although the SEC eventually adopted most of the recommendations of its advisory committee, it failed to accept the recommendation that one of the two data streams should include trades in all listed stocks other than those listed on the NYSE.<sup>214</sup> This failure was a concession to arguments by the AMEX that the identity of its market would be diluted by reporting trading in securities listed only on regional exchanges with trading in AMEX-listed stocks.<sup>215</sup> The Senate subcommittee stated that adoption in full of the SEC's advisory committee report was the only way to ensure competition between regional exchanges and the NYSE and the AMEX; otherwise, securities listed on regional exchanges could not receive the amount of publicity available to NYSE- and AMEX-listed stocks.<sup>216</sup> But expansion of the list of stocks reported on the tapes would result in the inclusion of securities of many companies that do not meet the standards of size and responsibility traditionally required by the AMEX. To resolve this problem, the subcommittee recommended authorizing the administrator of the composite reporting system to set minimum criteria for companies with securities in each data stream.<sup>217</sup> The subcommittee stressed the importance of neutrality on the part of the administering entity and suggested the establishment of a quasi-governmental body if no other satisfactory solution can be reached.<sup>218</sup>

212. See SEC Securities Exchange Act Release No. 9529 (March 8, 1972), 37 Fed. Reg. 5760 (1972); SEC Securities Exchange Act Release No. 9530 (March 8, 1972), 37 Fed. Reg. 5761 (1972).

213. Report to the SEC by the Advisory Committee on Market Disclosure on a Composite Transaction Reporting System, reprinted in BNA SEC. REG. & L. REP. No. 161, at E-1 (July 19, 1972).

214. See SEC Securities Exchange Act Release No. 9731 (Aug. 14, 1972), [1972-1973 Transfer Binder] CCH FED. SEC. L. REP. ¶ 78,938; SEC Securities Exchange Act Release No. 9850 (Nov. 8, 1972), [1972-1973 Transfer Binder] CCH FED. SEC. L. REP. ¶ 79,082.

215. SENATE REPORT, *supra* note 4, at 99.

216. *Id.*

217. *Id.*

218. SENATE REPORT, *supra* note 4, at 99-100. The New York, American, Midwest,

Very similar problems arise with the composite quotation system. The same criterion of neutrality to avoid discrimination between different market centers that applies to composite reporting of transactions also applies to reporting composite quotations. The SEC's advisory committee has suggested that the composite quotation system should be operated by the same entity that operates the transaction reporting system.<sup>219</sup>

b. *Uniformity of regulation among market centers.* The question of uniformity of regulation among market centers is closely inter-

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Pacific Coast, and PBW Stock Exchanges, together with the NASD, have submitted a two-network consolidated tape plan to the SEC. Network "A" would carry all sale prices of NYSE registered securities, regardless of where the transaction occurred. Network "B" would carry all last sale prices of securities registered on the American Stock Exchange, regardless of where the transaction occurred, plus information on securities registered on the Midwest, Pacific Coast, and PBW Stock Exchanges if such securities meet a test of "eligible securities" contained in the plan. To "avoid duplication" the Securities Industry Automation Corporation (SIAC) (essentially a pooling of automation services by the NYSE and the AMEX) would be designated as the recipient and processor of price information and the consolidated tape would be administered by a Consolidated Tape Association. The latter would consist of an eight-member, representative policy-making body, with the NYSE and the AMEX each being entitled to appoint two members (thus collectively comprising half the membership). Since the affirmative vote of five of the eight members would be necessary for any action by the Consolidated Tape Association, the NYSE and the AMEX, by acting together, could effectively veto further changes in the plan. In addition, proposed amendments to the plan would not be effective unless they receive the consent of any plan participant that reported to the processor (SIAC) 51 per cent or more of its daily closing prices reported on either network of the tape during the preceding twelve calendar months. This would give the two major exchanges further veto powers. For discussion of the composite tape plan, see BNA SEC. REG. & L. REP. No. 192, at A-9 (March 7, 1973); BNA SEC. REG. & L. REP. No. 193, at A-9 (March 14, 1973); BNA SEC. REG. & L. REP. No. 199, at A-9 (April 25, 1973). On June 13, 1973, the SEC recommended changes in the plan. As to eligibility standards for listing on the tape, the SEC proposed to apply the so-called "permanent" standards of the plan to *all* issues listed on the tape (thus precluding the application of lesser standards to securities that might otherwise be "grandfathered in" by being listed on regional exchanges when the plan goes into effect). After the plan is adopted subsequent listing of securities would be governed by standards akin to those presently imposed by the AMEX. Finally, under the SEC's proposal, the network would remain open for as long as a national securities exchange is open, provided that this is consistent with the SEC's normal business hours. SEC Securities Exchange Act Release No. 10218 (Jan. 13, 1973), 38 Fed. Reg. 15999 (1973). The SEC's proposals met with further resistance from the New York and American Stock Exchanges. See Wall St. J., July 16, 1973, at 2, col. 3 (eastern ed.); *id.*, July 19, 1973, at 8, col. 1. The NYSE issued a so-called "white paper," which in broad outline repeated arguments previously made that any tape system should be preceded by the establishment of uniform market making and other rules designed to reduce or eliminate price disparities in individual stocks traded in different markets. It also called for the abolition of the third market and the retention of restrictions on trading such as NYSE Rules 113 and 394, described in notes 226-27 *infra*. See Wall St. J., July 19, 1973, at 8, col. 1 (eastern ed.). The SEC, however, rejected demands by the NYSE that it delay the implementation of its proposal. See N.Y. Times, July 19, 1973, at 49, col. 8 (late city ed.). For further discussion of the problem of uniformity in regulation among market centers, see text accompanying notes 220-30 *infra*.

219. See discussion in Report to the SEC by the Advisory Committee on Market Disclosure on a Composite Quotation System, reprinted in BNA SEC. REG. & L. REP. No. 178, at H-1 (Nov. 22, 1972).

twined with other issues, such as the development of consolidated transaction reporting and composite quotation systems. Indeed, in a broad sense, it subsumes most of the problems that must be solved in creating a central market system. Today's market system is characterized by a wide disparity in regulation, which has led to undesirable forms of competition between market centers. There is little justification for allowing the execution of a transaction on a regional exchange merely to avoid disclosure. Similarly, market centers should not be permitted to compete with one another by adopting more lenient rules on institutional membership or on reciprocal practices of various types.<sup>220</sup> At a very minimum a central market system should be characterized by complete uniformity of rules pertaining to disclosure and access to the markets. In addition, there should be considerable uniformity in other rules, such as restrictions on manipulative practices.<sup>221</sup>

c. *Interface between the third market and the exchanges.* A particularly troublesome regulatory problem associated with the federated-markets proposal is that of providing a suitable interface between the third market and the markets on the exchanges. Trading on the exchanges is often described as an auction market where brokers act as agents and priority is given to public market or limit orders on the specialists' books. In contrast, trading in the third market currently provides no mechanism for giving priority to public orders, since third market makers generally act as dealers and trade on a net basis. However, the exchange markets are not pure auction markets, and they involve considerable dealer activity and prearranged assembly of block trades and block positioning.<sup>222</sup> Similarly, the over-the-counter market is not exclusively a dealer market but often combines agency and auction characteristics.<sup>223</sup> Although the two markets are different, it is easy to overemphasize the differences. The Senate subcommittee pointed out that "the question . . . is not whether the public is better served by an 'auction' or by a 'dealer' market, but what features of those two markets

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220. See HOUSE REPORT, *supra* note 4, at 129.

221. The inability of industry groups to agree on the desired degree of uniformity in specific rules has been an obstacle to the development of the central market system and particularly the development of composite transactional reporting. See *House Hearings*, *supra* note 5, pt. 7, at 3781-89. The SEC generally favors the federated-markets approach and advocates uniformity in regulation among market centers with respect to qualifications for exchange membership, short sales, and other manipulative practices, as well as disclosure of transactions. See SEC Market System Statement, *supra* note 206, at 31-32.

222. SENATE REPORT, *supra* note 4, at 106.

223. *Id.*

should be preserved in the developing central market system."<sup>224</sup> The subcommittee characterized the over-all goals of a central market system as "(1) [t]he maintenance of stable and orderly markets with maximum capacity for absorbing trading imbalances without undue price movements; and (2) [c]entralization of all buying and selling interest so that each investor will receive the best possible execution of his order, regardless of where it originates."<sup>225</sup>

The first objective may be achieved through modifying some of the restrictions presently imposed on specialists and block positioners,<sup>226</sup> modifying or repealing rules that restrict exchange members in executing trades in the third market when prices are more favorable than those prevailing on an exchange,<sup>227</sup> and subjecting market makers to duties akin to those imposed on specialists to create orderly and continuous markets in depth in those stocks in which they choose to deal.<sup>228</sup>

The second objective would be achieved by a requirement that

224. *Id.*

225. *Id.* at 107.

226. *Id.* at 106-15 (suggesting modification or repeal of NYSE Rule 113, 2 CCH NYSE GUIDE ¶ 2113 (1972), which precludes specialists from dealing directly with institutions and certain other persons, and of NYSE Rule 438, 2 CCH NYSE GUIDE ¶ 2438 (1970), which precludes firms from publishing bids and offers in listed securities).

227. SENATE REPORT, *supra* note 4, at 104-05 (suggesting modification of NYSE Rule 394, 2 CCH NYSE GUIDE ¶ 2394 (1973), which restricts member firms in their ability to engage in transactions in listed stocks other than on the floor of the NYSE). For a similar recommendation by the House subcommittee, see HOUSE REPORT, *supra* note 4, at 126-27. The SEC has concurred in the suggestion that rule 394 should be repealed, at a time no later than the date on which the composite quotation system is implemented. In the SEC's view, the rule should be replaced by a broader requirement that would confine all trading in listed securities to the central market system, without, however, eliminating the third market, which would be a part of the system. See SEC Market System Statement, *supra* note 206, at 63-64. The fourth market would also be retained. See note 206 *supra*. For recent discussion of the need for repeal of rule 394, see Russo & Wang, *supra* note 161, at 16-21.

228. See *House Hearings*, *supra* note 5, pt. 6, at 3094. See also *id.* at 3042, 3061. It is likely that even though affirmative obligations are imposed on market makers to make continuous and orderly markets in depth, the major impetus towards healthy market making will be competition. As the former Director of the SEC's Institutional Investor Study pointed out (with regard to the analogous problem of imposing affirmative duties on specialists):

Regulation at best can establish only minimal standards of performance and then tends to be more effective in prohibiting misconduct than in motivating persons to take positive steps to create and perfect a better marketplace. It is one thing to prevent a person, by rule, from "beating his wife"; it is quite another to attempt in the same way to require him to be "kind" to her.

*House Hearings*, *supra* note 5, pt. 6, at 2943-44 (statement of Donald B. Farrar). The SEC Market System Statement, *supra* note 206, at 33-34, proposes uniform rules regulating the activities of specialists on exchanges (thus rescinding certain exemptions from regulation hitherto enjoyed by specialists on regional exchanges), and also subjecting third market makers to comparable regulation by requiring the NASD to file a plan for regulating members of the system that are not also members of exchanges.

third market trades yield priority, parity, and precedence to outstanding public orders located anywhere in the central market system.<sup>229</sup> This might be done through automation, and, in all probability, it would entail automation of the specialists' books to provide disclosure of public orders to other specialists and market makers.<sup>230</sup>

229. See SENATE REPORT, *supra* note 4, at 112; HOUSE REPORT, *supra* note 4, at 128. The SEC Market System Statement, *supra* note 206, at 18-25, proposes to implement this concept by promulgating two rules. The first rule, referred to as the "auction trading rule," would provide "price priority protection for all public orders throughout the system." SEC Market System Statement, *supra*, at 18. All public orders would be stored in a central electronic repository and would have to be satisfied or "cleared" before a proposed transaction could take place. The SEC indicates that the clearance process would probably have to be performed by the facilities of the exchanges. Only public orders at better or equal prices would be protected. Thus, a public order to sell at  $39\frac{7}{8}$  must be filled before a block trade could clear at  $39\frac{3}{4}$ . *Id.* at 18-19. The SEC also indicated that it might be desirable to provide for "time priority protection" as well. Thus, if five bids are entered into the system at 49, the first bid to be entered would be given priority over the others. *Id.* at 18 n.21. Public limit orders might be permitted to participate in discounts generated by block trades if such limit orders are restricted in size (say, to 100,000 dollars in value). Thus, if a block trade were proposed at  $39\frac{5}{8}$ , limit orders on specialists' books to purchase at higher prices (e.g.,  $39\frac{7}{8}$ ) might be filled at the lower price ( $39\frac{5}{8}$ ) proposed for the block trade. The 100,000 dollar limitation would discourage professional traders who learn of a potential block, but who do not wish to purchase the entire block, from injecting themselves into the transaction to obtain bargain prices for part of the block merely by entering a higher "public" order. *Id.* at 20 n.24.

The second trading rule proposed by the SEC, known as the "public preference rule" would "accord preferential treatment to public orders by preventing any member of the system from participating as principal in any system transaction unless his purchase price is higher, or his sale price lower, than any public bid or offer recorded in the system." *Id.* at 22. The effect of the rule would be to preclude brokers from competing as dealers or principals with public orders except at better prices, thereby strengthening the auction market.

230. *Id.* For the House subcommittee's legislative implementation of its proposal, see H.R. 5050, 93d Cong., 1st Sess. §§ 208-09, 305 (1973). The bill would give the SEC until February 1, 1975, to establish a national market system and would require it to make annual reports of its progress in doing so to Congress. The SEC statement also advocates only that public limit orders be "entered into and stored in a central electronic repository by a specialist and . . . not be publicly available." SEC Market System Statement, *supra* note 206, at 18. Although the system would provide for automatic clearance of public orders entered into the system at better prices, a specialist would have actual knowledge only of limit orders that appear on his own books. Such inequality of information concerning limit orders may result in unfair advantages to some specialists, and the SEC concedes that "[i]t may be determined that the same result could be achieved more efficiently, although at the sacrifice of confidentiality, simply by making all limit orders available to all specialists." *Id.* at 18 n.22. It is arguable that equal access to limit orders should also be given to market makers if the latter are under obligations similar to those imposed on specialists. Senator Harrison A. Williams, Jr., has recently introduced S. 2519, 93d Cong., 1st Sess. (1973), a broad-ranging bill entitled the National Securities Market System Act of 1973, to implement further the Senate subcommittee's proposals relating to the markets, including the proposals to establish a consolidated tape and composite quotation system, to broaden the SEC's authority over the self-regulatory bodies, as discussed in text accompanying notes 108-42 *supra*, and to authorize the SEC to require specialists and market makers to give public orders priority over transactions by broker-dealers for their own accounts, as discussed in note 229 *supra*. The bill also directs the SEC



d. *Access to the central market system.* The question of access to the central market system is as controversial as is the problem of the appropriate market structure. In recent years growing demands by institutions for membership on national securities exchanges have accentuated the problem.<sup>231</sup>

The controversy over exchange membership for institutions has been intense and at times emotionally charged. The controversy arises from two salient facts: (1) Institutional membership tends to reduce commission dollars, which, absent such membership, would be received by exchange member firms for institutional accounts; and (2) the rules for membership on various exchanges have differed widely and have not been administered with impartiality.

The first point, if not entirely self-evident, is at least easily understood. If institutions do their own brokerage or are entitled to favorable commission rates because of their exchange membership, exchange member firms who might otherwise perform brokerage services for institutions and charge the full nonmember commission rate lose money. Since not all exchange member firms do substantial amounts of institutional business, the adverse impact of institutional membership in terms of lost commission dollars would be uneven, with some firms losing much more business than others. For example, of the value of orders of 500,000 dollars or more, five NYSE member firms accounted for thirty-seven per cent in the first quarter, forty-four per cent in the second quarter, and forty-nine per cent in the third quarter of 1971.<sup>232</sup> During the third quarter of 1971, orders of 500,000 dollars or more made up twenty-two per cent of the gross of NYSE member firms doing a retail business (in which the average order is for 300 shares or less), thirty-one per cent of the gross in intermediate-sized firms (where average orders range

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to forbid exchange or NASD rules that impose burdens on competition and are not "reasonably necessary" to achieve the purposes of the Securities Exchange Act. Among the rules that would be eliminated are those that restrict communication among market makers and specialists. See text accompanying notes 226-28 *supra*. In addition, the bill would permit stock exchanges to begin trading in certain unlisted issues, subject to SEC approval, without the necessity of formal action by the issuer's management to "list" the security on a particular exchange. For discussion of this point, see SENATE REPORT, *supra* note 4, at 133-35. For the text of the bill, see BNA SEC. REG. & L. REP. No. 221, at E-1 (Oct. 3, 1973).

231. State pension funds have recently joined the ranks of institutional investors wishing to acquire exchange membership. For example, the state of Connecticut has been given access to the PBW Stock Exchange through an affiliate, Connecticut Nutmeg Securities, Inc. See Wall St. J., Dec. 14, 1972, at 5, col. 1 (midwest ed.). Similarly, the New York City Finance Administrator has indicated an interest in an affiliate that might qualify for membership on the NYSE. N.Y. Times, Jan. 23, 1973, at 49, col. 8 (late city ed.).

232. See *House Hearings*, *supra* note 5, pt. 7, at 3716 (testimony of Robert W. Haack, president, New York Stock Exchange, Inc.).

from 300 to 1500 shares), and forty-five per cent of the gross of member firms doing primarily institutional business (where average orders exceed 1500 shares).<sup>233</sup> It should not be assumed, however, that all institutions would be anxious to join exchanges even if they were permitted to do so, especially if the breakpoint for negotiated rates were lowered further.<sup>234</sup> Exchange member firms that currently do institutional business would retain those institutional clients who did not choose to join exchanges. Notwithstanding this fact, it is still apparent that the aggregate effect of institutional membership on exchange member firms would be a substantial loss in commission dollars.

Until the recent SEC promulgation of rule 19b-2,<sup>235</sup> which attempts to achieve uniformity in exchange membership requirements, exchange rules concerning qualifications for membership have differed widely and have been unevenly administered. The NYSE and AMEX rules were the most strict, requiring that the "primary" purpose or activity of exchange member firms and their "parents" (any firm or institution controlling a member firm) be the transaction of business as a broker or dealer in securities.<sup>236</sup> These rules effectively excluded insurance companies and investment companies from membership on the nation's two largest exchanges. The rules of the regional exchanges varied from the relatively moderate rules of the Midwest Stock Exchange, which required a member firm to do at least fifty per cent of its business with nonaffiliates (thus permitting a firm to do up to fifty per cent of its business with an affiliated institution), to the much more lenient approach of the PBW Stock Exchange, which required only that its members be engaged in business as a broker or dealer in securities (and thus did not require them to do a public brokerage business). Institutions could therefore become members of the PBW Stock Exchange or achieve the advantages of PBW membership through ownership of an affiliated PBW member firm.<sup>237</sup>

Added to this disparity in rules among exchanges was an inconsistency in their administration. For example, the NYSE permitted its "parent" test to be either waived or liberally construed in several instances, apparently to favor individual firms or promote the

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233. *Id.*

234. See HOUSE REPORT, *supra* note 4, at 150.

235. 17 C.F.R. § 240.19b-2 (1973).

236. NYSE Rule 318, 2 CCH NYSE GUIDE ¶ 2318 (1973); AMEX Rule 314, 2 CCH AMEX GUIDE ¶ 9372 (1973).

237. For a general discussion of the membership requirements of the different exchanges, see SEC Securities Exchange Act Release No. 9950 (Jan. 16, 1973), 38 Fed. Reg. 3902, 3914 (1973).

rehabilitation of distressed member firms by the infusion of capital from institutional sources.<sup>238</sup> In addition, while the "parent" test effectively excluded institutions from exchange membership, it did not preclude exchange members from engaging in money management. Thus, exchange members could perform brokerage and act as advisers for investment companies as well as profit from increasing amounts of other forms of money management, particularly pension fund management; nonmember institutions, on the other hand, were at an economic disadvantage in competition with member firms in money management because of their inability to qualify for membership on the large national securities exchanges.

On January 16, 1973, the SEC adopted rule 19b-2,<sup>239</sup> ostensibly to achieve uniformity in the regulation of membership on national securities exchanges. The approach of the rule is to require that members effect at least eighty per cent of their business, calculated in terms of value of exchange securities transactions, for or with customers other than "affiliated persons."<sup>240</sup>

238. See Statement of Investors Diversified Services, Inc. & Jeffries & Co. 21-24 (Oct. 19, 1971), in *Public Investigatory Hearing on Structure of the Securities Markets Before the Securities & Exchange Commn.* (File No. 4-147, 1971), reprinted in *House Hearings*, *supra* note 5, pt. 9, at 4455, 4475-78. See also *id.* at 46-50, reprinted at 4500-04.

239. See SEC Securities Exchange Act Release No. 9950, *supra* note 237, at 3928. The rule is codified at 17 C.F.R. § 240.19b-2 (1973). The rule resulted from a proceeding brought by the SEC under section 19(b) of the Securities Exchange Act of 1934, 15 U.S.C. § 78s(b) (1970), which gives the SEC the power to initiate changes in exchange rules. The only other such proceeding was the so-called Multiple Trading Case (Rules of the New York Stock Exchange, 10 S.E.C. 270 (1941)), in which the SEC forced the NYSE to abrogate a rule that prohibited its members from trading dually listed stocks on regional exchanges.

240. The term "affiliated person" is defined as including

(i) any person directly or indirectly controlling, controlled by or under common control with such member, whether by contractual arrangement or otherwise, provided that the right to exercise investment discretion with respect to an account, without more, shall not constitute control;

(ii) any principal officer, stockholder or partner of such member or any person in whose account such person has a direct or material indirect beneficial interest; and

(iii) any investment company of which such member, or any person controlling, controlled by or under common control with such member, is an investment adviser within the meaning of the Investment Company Act of 1940.

17 C.F.R. § 240.19b-2(b)(1) (1973). "Principal officer, stockholder or partner" is defined in section (b)(3). See 17 C.F.R. § 240.19b-2(b)(3) (1973). "Control" is said to be presumed if "[a] person has a right to participate to the extent of more than 25 per cent in the profits of . . . [another] person or owns beneficially, directly or indirectly, more than 25 per cent of the outstanding voting securities of such person." 17 C.F.R. § 240.19b-2(b)(2) (1973).

Pension fund management is not *prima facie* "affiliated" business unless the 25 per cent test is met or there are other factors that indicate that the member firm "controls" the pension fund account. The status given pension fund managers is of particular importance since this type of money management is currently growing at a much more rapid rate than investment companies. It has been urged that pension fund management should be included under the rule, due to the high probability that a broker-dealer may have a form of *de facto* control over the pension fund account, although such account may still technically be under the control of the pension fund directors.

Since the technical aspects of the rule are amply discussed in an extensive SEC release that accompanied its adoption,<sup>241</sup> it seems appropriate to focus this discussion on the major policy problems involved. Foremost may be the SEC's decision to act in the face of opposition from the congressional subcommittees that had just completed extensive studies of their own and had recommended alternative solutions to the problem.<sup>242</sup> The SEC's action was also opposed by the Justice Department.<sup>243</sup>

See HOUSE REPORT, *supra* note 4, at 150-51. The SEC statement on the future structure of the securities markets, defines "nonaffiliated" persons as not including "institutional parents or investment companies or other institutional funds which are managed under contracts or arrangements which give the brokerage firm investment discretion." SEC Future Market Structure Statement, *supra* note 24, at 3457. For the SEC's current view of the matter, see SEC Securities Exchange Act Release No. 9950, *supra* note 237, at 3922. See also House Hearings, *supra* note 5, pt. 8, at 4152-53, 4160. See also *id.* at 4281-82.

The bill passed by the Senate prohibits (with certain exceptions) member firms from transacting exchange business for their own accounts, for the accounts of affiliates, or for a "managed institutional account." The latter term is defined as an account of a bank, insurance company, trust company, investment company, separate account, pension-benefit or profit-sharing trust or plan, foundation, or charitable endowment fund, or other similar type of institutional account "for which such member or any affiliated person thereof (A) is empowered to determine what securities shall be purchased or sold, or (B) makes day-to-day decisions as to the purchase or sale of securities even though some other person may have ultimate responsibility for the investment decisions for such account." S. 470, § 2, passed by the Senate, June 18, 1973, in 119 CONG. REC. S11366 (daily ed. June 18, 1973).

The NYSE has recently sought a highly restrictive interpretation of the term "affiliated person," which would, in effect, establish a conclusive presumption of "control" in specified situations, as well as a presumption that all institutional accounts managed by nonmember firms are deemed to be "controlled" accounts unless affirmatively shown to be otherwise. For the NYSE's position and a sharp criticism by Senator Williams in a letter to Acting SEC Chairman Owens, see BNA SEC. REG. & L. REP. No. 210, at A-11 (July 11, 1973). Recently, the SEC indicated its disapproval of the suggested change, pointing out that nonmember broker-dealers should not "be subjected to more rigorous criteria for access purposes than those established for brokers enjoying membership." Wall St. J., Aug. 31, 1973, at 7, col. 2 (midwest ed.). See SEC Securities Exchange Act Release No. 10391, BNA SEC. REG. & L. REP. No. 219, at F-1 (Sept. 19, 1973).

There are eight enumerated exceptions to the rule, see 17 C.F.R. §§ 240.10b-2(a)(1) to (8) (1973), which, according to the SEC's release, "are comprised of market-making transactions and other transactions which contribute to depth, liquidity, stability and continuity." SEC Securities Exchange Act Release No. 9950, *supra*, at 3921. The exceptions are: specialists' transactions and transactions by a block positioner (except where an affiliated person is a party to the transaction), certain stabilizing or arbitrage transactions, transactions effected in conformity with a plan adopted by the SEC and designed to eliminate floor trading activities that are not beneficial to the market, and transactions made with the prior approval of a floor official that contribute to the maintenance of a fair and orderly market.

241. See generally SEC Securities Exchange Act Release No. 9950, *supra* note 237.

242. Although at the time when the SEC rule was adopted the Senate subcommittee had not officially reached a decision on the question of institutional membership, the matter was under active consideration, and the views of the subcommittee chairman were well known. See Wall St. J., Jan. 19, 1973, at 5, col. 4 (eastern ed.); *id.*, Jan. 17, 1973, at 3, col. 1; *id.*, Oct. 12, 1972, at 17, col. 3.

243. *Id.*, Oct. 5, 1972, at 22, col. 2. The SEC's action also prompted a critical editorial in the New York Times (Jan. 25, 1973, at 38, col. 2 (late city ed.)).

In addition, the PBW Stock Exchange challenged the validity of the rule because the SEC had failed to permit institutions that had held exchange memberships prior to February 2, 1972, to continue their membership for a three-year period without declaring their intent to be bound by the rule. The PBW suit was dismissed by the third circuit for lack of jurisdiction; a majority of the panel held that the rule 19b-2 was not a reviewable order within the scope of the Securities Exchange Act.<sup>244</sup> Further litigation on this matter will no doubt be expensive and quixotic; the SEC is a powerful antagonist, and it may well prevail in the courts unless Congress takes some action to the contrary. Moreover, even if the PBW Stock Exchange were eventually to succeed, the victory might be a Pyrrhic one if it established the right of an institution to join any national securities exchange. Since institutions would in that event undoubtedly choose to join the NYSE and the AMEX, there would be less reason for them to seek membership on regional exchanges such as the PBW.<sup>245</sup> Finally, as a consultant to the PBW Stock Exchange pointed out, if the Exchange were forced by the SEC to exclude persons from its membership it would be in a "strong position with respect to antitrust considerations."<sup>246</sup>

Perhaps illustrating the statement that "[a] regulatory agency usually becomes dominated by the industry which it was created to regulate,"<sup>247</sup> the rule received a warm welcome by the NYSE, whose recently appointed chairman (formerly an SEC commissioner) described it as "a major step in the public interest toward the creation of a central securities market."<sup>248</sup> In all fairness, however, one should examine the underlying policy justifications given by the SEC for its action, the most important of which was its belief that

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244. *PBW Stock Exch., Inc. v. SEC*, 42 U.S.L.W. 2191 (3d Cir., Sept. 28, 1973). The Exchange had originally agreed to withdraw its opposition to the rule in return for an SEC promise to phase the rule in over a three-year period. See *Wall St. J.*, Feb. 9, 1973, at 6, col. 2 (eastern ed.); *N.Y. Times*, Feb. 9, 1973, at 45, col. 5 (late city ed.).

In addition, the Treasurer of the State of Connecticut has asked that the Justice Department contest the validity of the rule under the antitrust laws. See *BNA SEC. REG. & L. REP.* No. 188, at A-2 (Feb. 7, 1973). The Justice Department has urged a federal district court in *Thill Sec. Corp. v. NYSE*, 433 F.2d 264 (7th Cir. 1970), *cert. denied*, 401 U.S. 999 (1971), to outlaw fixed brokerage commissions for all exchange member firms by no later than July 1974. See *BNA SEC. REG. & L. REP.* No. 201, at A-13 (May 9, 1973). For the SEC's brief in the PBW case, see *BNA SEC. REG. & L. REP.* No. 202, at D-1 (May 16, 1973).

245. See *BNA SEC. REG. & L. REP.* No. 181, at B-6 (Dec. 13, 1972).

246. See *N.Y. Times*, Nov. 30, 1972, at 69, col. 3 (late city ed.).

247. *Thill Sec. Corp. v. NYSE*, 433 F.2d 264, 273 (7th Cir. 1970), *cert. denied*, 401 U.S. 994 (1971).

248. *N.Y. Times*, Jan. 25, 1973, at 38, col. 2 (late city ed.), quoting James J. Needham.

unrestricted institutional membership would severely undermine the SEC's asserted objective of gradually phasing in negotiated rates, lowering the breakpoint in stages, and monitoring the industry for adverse effects. If institutions were permitted to become members of exchanges for the purpose of recapturing commissions, "that would be tantamount to competitive rates (or no commissions at all) on all size orders for those institutions immediately; the Commission's phase-in program would then become an academic exercise, at best."<sup>249</sup> The SEC also believed that institutional membership on regional exchanges, if permitted to continue without substantial restrictions, might result in a change, perhaps irreversible, in the entire character of the securities markets. The emphasis might shift away from the auction process to a dealer market dominated by institutions trading primarily for their own benefit. Such a market might create abuses akin to those traditionally associated with "floor traders" and might further discourage small investors from participating.<sup>250</sup>

While not without merit, these policy considerations do not account for the manner in which the SEC acted. The SEC's objectives could have been achieved equally well (if not more satisfactorily) if it had adopted the approach suggested by the congressional subcommittees, namely to condition exchange membership on a firm's doing *all* of its business with nonaffiliates (instead of eighty per cent). The SEC's eighty per cent solution was ostensibly justified by the need to proceed cautiously and gradually, with a "flexible" approach that would not entail "undue disruption of the capital-raising mechanism of our economic system."<sup>251</sup> As pointed out by the House subcommittee in its report, however, this test merely exacerbates existing problems by encouraging larger firms that do extensive institutional business to compete more aggressively with smaller regional firms in order to acquire more "public" business to meet the eighty per cent requirement.<sup>252</sup> Indeed, according to the Justice Department, the SEC's new test might result in a "wave of mergers between institutional investors and leading brokerage firms that are already members on an exchange. This would not be desirable."<sup>253</sup> In addition, the percentage test might create difficult bookkeeping problems and encourage "churning" of public customers' accounts to increase business if

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249. SEC Securities Exchange Act Release No. 9950, *supra* note 237, at 3916.

250. *Id.* at 3917-19.

251. *Id.* at 3920.

252. See HOUSE REPORT, *supra* note 4, at 152.

253. HOUSE HEARINGS, *supra* note 5, pt. 8, at 4119 (statement of Donald I. Baker).

necessary to meet the eighty per cent requirement. Although the SEC argued that the antitrust laws are "more than adequate" to prevent undesirable mergers within the industry and that it would itself be able to prevent unlawful "churning" through the use of its existing administrative powers,<sup>254</sup> it seems anomalous to adopt a rule that might increase the likelihood of such unlawful activity and, consequently, the administrative burden and cost of preventing it.<sup>255</sup>

The salient feature of the controversy is that the SEC, as a statutory creature, presumably responsive to congressional control and oversight, has a heavy burden of proof to justify its activities in an area that is likely to be dealt with differently on a legislative level. On the other hand, it could be argued that the SEC may be acting within its statutory powers<sup>256</sup> and that it would be a dereliction of its duty to stand idly by while the matter is resolved through a more lengthy and cumbersome legislative process, particularly if the legislative outcome is itself uncertain.<sup>257</sup> This argument, how-

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254. SEC Securities Exchange Act Release No. 9950, *supra* note 237, at 3939 n.409.

255. It should be noted that under the SEC's rule, as well as under the various proposals made by the congressional subcommittees, there may be a persistent administrative problem in policing attempts to evade the rule by various types of reciprocal business practices. Thus, one institution may informally agree with another to place brokerage with the other institution's affiliated member firm in exchange for an equal amount of commission business sent by that other institution to the first institution's affiliated member firm. The House report recognized the problem but saw no practical solution other than to rely on the SEC to monitor the situation closely and "take whatever steps are needed to prevent this type of reciprocal business." HOUSE REPORT, *supra* note 4, at 152-53. The bill passed by the Senate makes it "unlawful . . . to utilize any scheme, device, arrangement, agreement, or understanding designed to circumvent or avoid, by reciprocal means or in any other manner, the policy and purposes of this subsection." S. 470, § 2, passed by the Senate, June 18, 1973, in 119 CONG. REC. S11366 (daily ed. June 18, 1973).

256. Compare SEC Securities Exchange Act Release No. 9950, *supra* note 237, at 3907-14, with HOUSE REPORT, *supra* note 4, at 152 n.25. The question whether the SEC has power to deal with the problem of exchange membership is troublesome, and the legislative history is not entirely clear. Section 19(b) of the Securities Exchange Act, 15 U.S.C. § 78s(b) (1970), does not expressly confer authority on the SEC to act with respect to rules on exchange membership. Any SEC power in this area must be implied from its authority to deal with "the fixing of reasonable rates of commission . . . and other charges" (subsection 19(b)(9)) or its authority over "similar matters" (subsection 19(b)(13)) (*i.e.*, matters similar to those enumerated expressly in subsections 19(b)(1)-(12)). Thomas Corcoran, one of the draftsmen of the Securities Exchange Act, at one point expressed his view that the SEC did have power in this area. See *Hearings on H.R. 7852 and H.R. 8720 Before the House Comm. on Interstate and Foreign Commerce*, 73d Cong., 2d Sess. 125 (1934).

257. In view of the fact that the SEC's rule has been favorably received by most of the exchanges (except for the PBW Stock Exchange, *see* text accompanying note 244 *supra*) there is a very real question of whether more restrictive legislation will be passed without the support of significant segments of the industry and the SEC. More recently, SEC Commissioner Loomis indicated to the House subcommittee that he was in general agreement with the sections of the House bill dealing with commission rates and access

ever, appears to lose sight of the overwhelming importance of permitting the democratic process to operate on an issue of such pervasive significance.

The House subcommittee has introduced a bill to implement its recommendations and to prohibit exchange members from transacting business with affiliated persons after February 1, 1974, the deadline set by the subcommittee for reducing the breakpoint for negotiated rates to 100,000 dollars. Included in the definition of affiliated persons are pension, profit-sharing, or similar plans where an exchange member has investment discretion or with respect to which it regularly furnishes investment advice. Persons who were exchange members prior to February 1, 1973, are given a period of not more than one year from the effective date of the legislation within which to comply with its provisions.<sup>258</sup> The Senate has already passed a bill dealing with institutional membership.<sup>259</sup>

## V. CONCLUSION

The various studies of the securities industry that resulted from the crisis period in the late 1960's have given rise to a broad-ranging program of legislative and administrative reform. Broker-dealer financial stability will be strengthened by more uniform rules on net capital, use of customers' funds and securities, clearance and settlement procedures, standards for entry into the securities business, as well as accounting, auditing, and reporting procedures. Self-regulation, a unique characteristic of the industry from the inception of securities regulation, will persist, but it will be strengthened and reinforced through increased regulatory control by the SEC, with particular emphasis on ensuring fairness and adequate review of disciplinary and other proceedings (including rule-making) by self-regulatory bodies. The SEC itself will be strengthened through increased budgetary allotments, as well as legislative reforms that will ensure the effective use by Congress of its oversight functions. Tensions that have arisen as a result of pressures brought to bear by increasing institutionalization of the markets on the system of fixed

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to the central market system (*e.g.*, institutional membership), arguing only that there be greater flexibility in the timetable for implementing full competitive rates. BNA SEC. REG. & L. REP. No. 206, at A-19 (June 13, 1973).

258. H.R. 5050, 93d Cong., 1st Sess. § 205 (1973). For comparable legislation passed by the Senate, see S. 470, § 2, passed by the Senate, June 18, 1973, in 119 CONG. REC. S11366 (daily ed. June 18, 1973). See note 240 *supra*. Senator Sparkman has introduced a measure that would postpone the effective date of prohibiting exchange members from doing business with their affiliates for ten years, which is his suggested phase-in period for negotiated rates. S. 488, 93d Cong., 1st Sess. (1973).

259. See text accompanying notes 189-92 *supra*.



commission rates will eventually be resolved through the implementation of negotiated or competitive rates. Although the abandonment of fixed commission rates may have an adverse effect on inefficient firms, well managed firms (including smaller regional firms) will survive and indeed will flourish under competitive rates. Fears that this will lead to concentration of brokerage business in the hands of a few large firms are unjustified. Similarly, there is little evidence that competitive rates will have an adverse effect on the markets themselves, or on smaller investors. Indeed, fixed rates have, in the past, been a major impediment to the establishment of a central market system. Such a system, characterized by greater uniformity in regulation and disclosure among competing market centers, will result in extensive savings to large and small investors alike, as well as to securities firms dealing on their behalf. These savings will in turn encourage firms to engage in more business for smaller investors. The market itself will thus become a more attractive investment vehicle for large numbers of persons with a diversity of investment objectives. These reforms will strengthen the present auction market, rather than lead to its demise, as predicted by some critics. Access to the system will be available to all broker-dealers qualifying under suitable professional and financial standards. Institutions, if they care to become members of the market system, may do so on the conditions that they perform no brokerage for themselves and that no such brokerage be performed for their account by an affiliated member firm.